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CONFIDENTIAL FILING

PRIME MINISTER'S MEETING WITH SIR BRANDON RHYS WILLIAMS ON ~~26~~ 27 NOVEMBER 1986 and subsequent meetings

PRIME MINISTER

NOVEMBER 1986

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~11.11.86~~							
~~19.11.86~~							
~~25.2.87~~							
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~~25.3.87~~							
~~6.4.87~~							
25.11.87							

PREM 19/2422

PRIME MINISTER

MEETING WITH SIR BRANDON RHYS WILLIAMS

Sir Brandon Rhys Williams is attending a Deutschebank Conference at the weekend about international monetary affairs. He wants to touch base with you before he goes.

His main purpose I believe will be to say that he supports you on the EMS, but he will no doubt also mention to you his familiar ideas for closer monetary integration in the European Community. I am not sure how he reconciles these two positions.

D. R. Norgrove
25 November 1987

From Sir Brandon Rhys Williams M.P.

R24/11

HOUSE OF COMMONS
LONDON SW1A 0AA

23rd November 1987.

Dear Margaret,

I would like to congratulate you on your firm stand over sterling and the E.M.S. It would be most imprudent to tie the pound and the D-Mark in a tight numerical relationship: it would be like a solar system with two suns moving eccentrically.

At the same time, events are making it clear that we need to make progress towards an orderly relationship in the European money markets. London could lead the way - and should.

Archie says that I may be able to catch your eye on Thursday. I am attending the Deutsche Bank-sponsored conference in Frankfurt at the weekend. Yours ever Brandon.

To The Rt. Hon. The Prime Minister.

file

DSG

bc: DG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

6 April 1987

SIR BRANDON RHYS WILLIAMS

The Prime Minister has seen your letter to me of 3 April about Sir Brandon Rhys Williams' proposals for a Bill on audit committees. She is glad your Secretary of State and the Chief Whip have reached a satisfactory agreement with Sir Brandon.

I am copying this letter to Alex Allan (HM Treasury) and Murdo Maclean (Chief Whip's Office).

David Norgrove

DTI

Paul Steeples, Esq.,
Department of Trade and Industry.

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215) .....
(Switchboard) 01-215 7877

Secretary of State for Trade and Industry

PS/

3rd April 1987

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Prime Minister 4
The deal is that Sir Brandon's Bill can go forward into Committee stage provided he allows it to fall gracefully thereafter.
Good DRN 3/4.

Dear David

SIR BRANDON RHYS WILLIAMS

Thank you for your letters of 26 February and 25 March about the Prime Minister's views on how to handle Sir Brandon Rhys Williams' proposals for a Bill on audit committees.

My Secretary of State felt that, since the use of scarce Parliamentary time was potentially involved, he should discuss the position with the Chief Whip before reaching any decisions. He then agreed with the Chief Whip that it would be preferable for the Chief Whip to meet Sir Brandon and explain the position. Following that discussion, my Secretary of State has now written to Sir Brandon on lines agreed with the Chief Whip - a copy of the letter ... is enclosed. As you will see, these arrangements do include allowing the Bill to go into Committee and the offer of help to Sir Brandon on deciding what his Bill should aim to cover.

I am copying this letter to Alex Allan (HM Treasury) and Murdo Maclean (Chief Whip's office).

Yours
Paul

PAUL STEEPLES
Private Secretary

Encl
JF4ATF

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 01-215 7877

Secretary of State for Trade and Industry

31 March 1987

Sir Brandon Rhys Williams MP
House of Commons
LONDON
SW1A 0AA

Dear Brandon,

When we met last month I promised to consider your draft Bill and let you know what my reply would be. Since then you have kindly let me have the notes on which it will be based. I have now had a chance to look at these and to discuss the handling of the Bill with the Chief Whip.

Clearly the Government itself cannot guarantee the passage of a Private Members Bill, but I would be happy to see your Bill get a Second Reading, although obviously I cannot prevent someone else blocking it. On the assumption that it does get a Second Reading, then it will be committed to Standing Committee C. How it progresses there is not in the Government's control but I hope that it may prove possible to have up to two or three days in Committee. As you will appreciate, any further progress must depend on the time available in the House for Private Members bills and the competition from other such bills. However, I much appreciate your agreeing to take the Chief Whip's advice on the question of the remaining stages. I do feel that discussion of your Bill would be a very helpful complement to the consultations which we are already starting on these issues.

You also asked whether you could meet officials here to obtain their help in the drafting of your Bill. Obviously its detailed drafting must be for you to arrange, but you may find the attached comments useful, and if you do wish for some further help in

JF4ASR

deciding how much to aim to cover, I suggest you approach Dennis Gatland, the Assistant Secretary who has taken over responsibility for this area. His telephone number is 01-215 3199.

I hope that this reply will be helpful.

Yours,

PAUL CHANNON

JF4ASR

NOTES ON SIR BRANDON RHYS WILLIAMS OUTLINE OF HIS BILL

APPOINTMENT OF DIRECTORS

Rules about appointment in new form of Table A

Companies formed before 1985 can readily adopt the new form of Table A if they wish. If the management of the company does not take the initiative, resolutions to change a company's articles can be requisitioned by a small proportion of shareholders (see para 7 below). A statutory requirement to adopt Regulations 76 to 80 would deprive companies of their existing right to determine their own arrangements for appointing directors.

Register of Directors and Secretaries

2 Information about an individual's experience and qualifications is particularly relevant before someone is appointed as a director. The value of including this information in the Register is doubtful. Also, it is a criminal offence not to place on the register the required particulars - S288(4). While the particulars set out in S289 (in respect of Directors) and in S290 (Secretaries) are capable of precise answers, to require directors to disclose their previous business or professional experience and qualifications could easily lead to some inadvertant omission and therefore breach the law in circumstances where criminal penalties would seem inappropriate.

Directors' Report to contain details included in the S289 Register

3 The register can be inspected free of charge by any member of the company or upon payment of 5p by any other person at the registered office. Substantially the same information is contained on the public register at Companies House. To require its duplication in the Directors report would therefore seem unnecessary and would add significantly to the length of that report. At most it would seem desirable to have a requirement that the register be available at the AGM.

A more explicit obligation to buttress Schedule 7, para 6(b)

4 S221 (1) & (2)(a) already require the keeping of accounting records sufficient to disclose the financial position of the company at any one time. It is not clear what additional information the proposed new clause is seeking to make available to the directors and it does not provide any sanction for not complying with the proposed new requirement. As to auditors, they have already a statutory right of access to the books, accounts and vouchers of the company and are entitled to require from the company's officers such information and explanations as are necessary for the performance of their duties - S237(3). The directors are of course vulnerable to liability for fraudulent and wrongful trading (S. 458 of Companies Act 1985 and Ss213 and 214 Insolvency Act 1986). This should in itself provide a powerful incentive to ensure that they keep the financial position under review at all times, and not just once

a year as required by the draft clause.

5 As to the proposal that the auditors should be required to report on the preparation of the Directors' Report insofar as it is required to comply with Part 1 of Schedule 7, some of the matters in that Part will not be within the auditors' knowledge. In particular, likely future developments in the business of the company are not something the auditors would be in a position to report on. They already have a duty (under S.237(6)) to refer to the fact in their report if they consider the information given in the Directors' Report is inconsistent with the accounts.

Amendment to Schedule 7, paragraph 3(1)

6 The suggested wording is likely to be construed by the courts according to the eiusdem generis rule as only covering things akin to political and charitable gifts. Payments of the kind mentioned would almost certainly not be regarded as coming within the definition of "gifts". In order to ensure that the mischief identified is covered it would be preferable to list specifically the types of payment to be disclosed, but it must be doubtful how effective such a provision would be in securing the disclosure of illicit payments.

Audit Committees

7 There is already a right for a small group of shareholders to requisition a resolution which could be used to put forward the proposal for the appointment of an audit committee. 1/20 of the members of a company or 100 members with an average between them of £100 can already requisition a resolution including a resolution to amend the articles (S376). It may be that a lower limit is envisaged. But it must be questioned whether such a new right would have much effect even in securing debates about the merits of establishing an audit committee in a particular company. As far as we know, the existing right is very rarely used. Institutional shareholders must often be in a position where they could use the existing right. The new right would make it easier for smaller shareholders to secure a discussion about audit commitees but they can already ask questions at AGMs and the absence of any evidence of pressure to set up such committees suggests that little use would be made of the proposed new right.

Stock Exchange "Encouragement" for audit committees

8 The proposal that The Stock Exchange should be encouraged to make it a condition of listing for at least "alpha" companies that they should have audit committees may well be worth pursuing. We do not know what The Stock Exchange's views might be. The listing rules are a matter for them, not for primary legislation. The rules do, however, now have a statutory effect - they are made under the terms of Financial Services Act 1986. This has a number of consequences which would need to be taken into account. Firstly there are no powers to discontinue listing because of a condition imposed ex post facto on companies already on the list. Secondly the sanctions available

breaches of the listing rules have implications which may be considered undesirable, in that any breach can lay companies open to private suit for damages by third parties.

Bank of England "Encouragement" for Audit Committees

9 There are new clauses in the Banking Bill on this matter.

Definition of independent non-executive director

10 It is only necessary to have a definition in legislation if there are substantive provisions which would call it up. At present there are none which require the suggested definition of independent non-executive directors. Even if a Model Code for audit committees were included which referred to non-executive directors, it would not follow that a general definition was needed as opposed to a definition for the purpose of the code. The introduction of a general definition would raise the issue of whether the duties and liabilities of executive and non-executive directors should remain the same or whether there should be some lower standard for non-executive directors. There are also a number of difficulties about the definition. One is identified in the paper - service on an audit committee is not to disqualify a director from being regarded as an independent non-executive director. But non-executive directors also often take on many other functions, for example, sitting on Board and other committees, chairing working groups on specific topics, and undertaking representational activities. Should such activities disqualify the director from being regarded as non-executive?

Department of Trade and Industry

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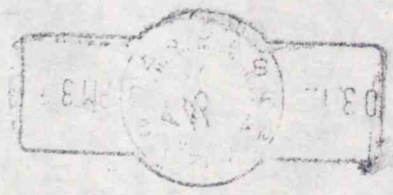
PM

MTG WITH

BRANDON MAYS WILLIAMS

11/16



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a BG
cc CW

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

25 March 1987

Dear Paul,

SIR BRANDON RHYS WILLIAMS

I wrote to you on 26 February recording the Prime Minister's meeting with Sir Brandon Rhys Williams on that day at which Sir Brandon's ideas for the appointment of Audit Committees were discussed.

The Prime Minister remains concerned that Sir Brandon's ideas should be given a sympathetic hearing and debated in the House of Commons at the very least. Indeed the Prime Minister is inclined to believe that his Bill should be allowed to go into Committee. She returned to this at a meeting yesterday, and I should be grateful to know where matters now stand.

I am copying this letter to Alex Allan (HM Treasury) and Murdo Maclean (Chief Whip's Office).

Yours,
David.

David Norgrove

Paul Steeples Esq
Department of Trade and Industry.

SUBJECT
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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

26 February 1987

Dear Paul,

MEETING WITH SIR BRANDON RHYS WILLIAMS

The Prime Minister this afternoon met Sir Brandon Rhys Williams to discuss his proposals for the appointment of Audit Committees, on the basis of his letter of 24 February. The Economic Secretary, Treasury and Mr Michael Alison, Prime Minister's Parliamentary Private Secretary, were also present.

Sir Brandon explained the advantages of Audit Committees much along the lines of his letter. They would help to provide a check on the activities of the directors of companies and might also give helpful advice to prevent the decline of companies which might otherwise fall into serious difficulties. Sir Brandon also explained his proposals to increase the powers of shareholders, for example requiring particulars of directors to be circulated before the AGM and also giving those who might wish to stand against existing directors the same facilities to send their own particulars to shareholders. This provision was now in force for companies created after 1985. But it could be extended more widely.

The discussion concentrated on the proposals for Audit Committees, which might include either executive directors or non-executive directors or both. The Prime Minister pointed to the difficulty of securing the services of enough competent non-executive directors. Sir Brandon on the other hand argued that all companies quoted on the New York Stock Exchange were required to establish Audit Committees (though he was not sure whether they also had to include non-executive directors) and he drew attention to the uncertainty and narrowness of the circumstances in which auditors might take action over actual or potential criminal acts. A useful presumption in favour of Audit Committees and non-executive directors had been created through the Banking Bill. Sir Brandon urged that his latest Private Member's Bill should be considered sympathetically by the DTI and allowed a Second Reading so that the issues could be aired.

The Prime Minister agreed and told Sir Brandon that she would ask for the DTI's comments on his proposals. I should be grateful if you could therefore let me have your reactions to his ideas. The Prime Minister is I believe sympathetic in principle to a more general extension of the arrangements which have emerged in discussion of the Banking Bill, perhaps to large companies in the first instance. She would be disposed to agree that Sir Brandon's Bill should be given a second reading so that his ideas can be discussed.

I am copying this letter to Peter Barnes (Economic Secretary's Office, HMT).

Yours,

David.

David Norgrove

Paul Steeples Esq
Department of Trade and Industry

PRIME MINISTER

MEETING WITH SIR BRANDON RHYS WILLIAMS

Sir Brandon Rhys Williams wishes to discuss his proposals that private companies should be required in legislation to appoint audit committees and non-executive directors. He says he has made this proposal every year since 1969 and he has only recently sent another Private Members Bill to Mr. Channon for comment.

I and Mr. Stewart or Mr. Howard will be attending the meeting and will arrive 10 minutes early for a briefing.

You will remember that Sir Brandon persuaded the committee on the Banking Bill to push through clauses requiring banks to appoint non-executive directors and audit committees. These clauses would have been unworkable and a compromise has been reached which Sir Brandon finds just about acceptable. He is now presumably going to urge you to support his ideas for making the provisions much more widely applicable.

The brief by the DTI sits on the fence. Clearly in the past there has been very strong opposition to such a requirement and they did not wish to force the proposal on antagonistic companies. But opinion has been changing. I think you will want to ask Mr. Stewart or Mr. Howard what exactly the objections are to the proposals, which on the face of it seem to make a lot of sense, for large companies at least.

pp. DUTY CLERK
(DAVID NORGROVE)
25 February 1987

DCABTI

From Company Auditing – Lee 1980. Pages 41-42.

Illegal Acts and the Auditor

In addition to the familiar fraud and error items which could distort the financial results contained in audited financial statements, the auditor is likely to meet other unlawful acts and defaults by managers and employees within client companies. If these affect the financial statements he is auditing, then obviously the auditor has a duty to consider whether or not they are material to the judgement he has to make when giving his opinion on these statements. However, many of these acts may fall outside the expected limits of the audit and, in these circumstances, the auditor has a considerable problem with regard to whether or not he can disclose what he has found, and to whom. The present situation in the UK is reasonably summed up in a guidance statement of the Institute of Chartered Accountants of Scotland:[15]

> 'The Council . . . recommends that members, albeit they may be contractually free to do so, should not disclose past or intended civil wrongs, crimes (except treason, which they are legally obliged to disclose) or statutory offences unless they feel that the damage to the public likely to arise from non-disclosure is of a very serious nature and that in any such case members should if time allows always take legal advice before making the disclosure.'

Thus, although this advice does not appear to extend the company audit function beyond its existing limits as described in this chapter, the question of actual or potential illegal acts which the auditor may come across during his audit raises certain problems for him other than whether or not he should breach the expected confidentiality of the contract with the client company. These are as follows:

1. As mentioned above, he must consider whether or not the actual or potential illegal acts bear upon the financial statements which he is attesting. He will require to allow for them in the audit work which he executes prior to giving his opinion. In other words, if his suspicions are aroused, he must pursue the matter of illegal acts until either his suspicions are removed or they are confirmed (in which case they will become part of the evidence upon which the ultimate audit opinion will be based).

2. The auditor will also require to consider whether or not the actual or potential illegal acts may have distorted past financial statements on which he has given an opinion, and which may also require a reassessment of that opinion. In these circumstances, he should not only ensure that company management is made aware of these acts, but also that it adequately discloses appropriate information about them to shareholders and other users in order that they are fully appraised of the situation.

3. Given the statutory right of the auditor to resign his office (with an adequate statement of the circumstances being given by him to the shareholders), he must consider whether the question of illegal acts by company management or employees is sufficient to require him to resign his office. This is a personal judgement, but he should remember his need to give due notice of his resignation, and an adequate statement of the circumstances leading to it.

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SCB/UP.

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ECONOMIC SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

David Norgrove Esq
10 Downing Street
LONDON
SW1A 0AA

25 February 1987

Dear David

PRIME MINISTER'S MEETING WITH SIR BRANDON RHYS WILLIAMS MP

The Prime Minister is seeing Sir Brandon Rhys Williams at 3.55 pm tomorrow, and the Economic Secretary will be giving her oral briefing for 10 minutes at 3.45 pm.

I attach written briefing for the Prime Minister, prepared jointly by Treasury officials and the DTI. This has been approved by the Economic Secretary but not yet cleared with the Chancellor.

As the Government accepted amendments on non-executive directors in the Banking Bill at Report, Sir Brandon may be more interested to put the case for non-executive directors for all public limited companies, rather than to emphasise authorised institutions in particular. A separate line to take, prepared by the DTI, is attached.

I am copying this letter to David Roe in Mr Michael Howard's office at the DTI.

Yours sincerely,

Peter Barnes

P D P BARNES
Private Secretary

BANKING BILL: NON-EXECUTIVE DIRECTORS AND AUDIT COMMITTEES

MEETING WITH SIR BRANDON RHYS WILLIAMS (26 FEBRUARY)

Introduction

1. Sir Brandon Rhys Williams has for many years sought to create a statutory requirement for companies to have non-executive directors and to form audit committees. While his campaign is directed mainly at company law he and others sympathetic to his cause have seized on the Banking Bill as a vehicle to put such requirements into statute for the first time. At present the Bill contains compromise provisions which give the Bank of England discretion to require non-executive directors and audit committees in banks where appropriate. Sir Brandon may use this meeting to argue that the Banking Bill should go further. But it is also quite possible that he will wish to discuss his private members Bill and general company law. This brief covers the Banking Bill. A separate brief on the general issues, provided by DTI, is attached.

Background

2. As introduced, the Banking Bill did not include a requirement for banks to have either non-executive directors or audit committees. But independently of the Bill the Bank of England have been strongly encouraging such developments. (A consultation paper on this topic was issued by the Bank of England on 30 January.) In Committee Mr Anthony Nelson and other Committee members sympathetic to Sir Brandon's campaign tabled two new clauses for the Bill. One required all banks to have at least 3 non-executive directors (defined in very demanding terms including, for example, their not having been employed by the bank concerned for the past 15 years). The other required all banks to have audit committees composed mainly of non-executive directors. This clause also spelt out the functions and powers of such a body. These new clauses were passed in Committee despite a Government undertaking to introduce alternative amendments on report.

3. Between Committee and Report, a compromise was reached with Mr Nelson resulting in the provisions currently in the Bill. These give the Bank discretion to require non executive directors and audit committees where appropriate. The Bank of England have also given a public commitment to "see that all major banking groups establish an audit committee and that in all cases, unless there are sound reasons to the contrary, at least one non-executive director is appointed who can undertake some of the audit committee functions". The discretion is designed to allow the Bank to exclude cases where the earlier proposals would not be practicable: for example: where an institution is very small, where it is a wholly owned subsidiary in a banking group or where it is incorporated overseas and is under a different companies regime. Sir Brandon's reaction to the compromise proposals, before hearing the Bank of England undertaking, was that they 'barely meet the case, but they do meet it for the present.'

Recommended Line to take

4. The new provisions in the Banking Bill coupled with the Bank of England's undertaking represents a significant and worthwhile step forward in promoting the role of non-executive directors and audit committees. (Would not be practical to place inflexible mandatory requirements on all banks as the new clauses introduced in Committee sought to do.) Inappropriate to seek further changes, which are really concerned with company law, in a banking bill.

Points for use in discussion

- The new Bill, as amended on report, brings the concept of non-executive directors into statute for the first time and is therefore a significant step forward.

- Bank of England have given a very firm undertaking to insist on non-executives and audit committees where appropriate.

- Danger, in going further in the Banking Bill, of being impractical for some banks.

- Danger also that more explicit Banking Bill provisions would cast into doubt existing company law which does not distinguish

between directors: one class might then claim that the Banking Bill made clear that their duties were not the same as the other class and therefore they were not responsible in certain matters.

Attachments

5. The DTI brief on the general issue is attached. Also attached are a copy of the Report Stage debate on this issue at 'A', a copy of the Bank of England's consultative paper at 'B', and a copy of Sir Brandon's recent letter to the Secretary of State describing his latest private members Bill (yet to be published) at 'C'.

C. NON EXECUTIVE DIRECTORS AND AUDIT COMMITTEES

GENERAL BRIEF BY DTI

NON EXECUTIVE DIRECTORS AND AUDIT COMMITTEES FOR ALL PUBLIC LIMITED COMPANIES

Line to Take

1. Sir Brandon has performed a most useful service in calling attention to the wider commercial and economic significance of company law.

2. For some years the Government has encouraged the appointment of non-executive directors on a voluntary basis.

3. While the majority of opinion has in the past been firmly opposed to his proposals his views have attracted more sympathy recently.

4. While it would be premature to give any commitments as to the Government's attitude towards his forthcoming Bill - the case for compulsion remains unproven - and it is not sensible to amend technical law of this kind without extensive consultations - the Secretary of State for Trade and Industry is considering Sir Brandon's latest thinking as given in his letter of 16 February.

Background

5. For over 15 years Sir Brandon Rhys Williams has introduced a series of Companies Bills whose main object is to subject those who manage major public limited companies to more supervision, because of the failure of shareholders properly to exercise such supervision. In return for the privilege of limited liability shareholders should ensure, in the national interest, that their companies are competently, efficiently and honestly managed, but they increasingly fail to do so. In order to avoid more government intervention some effective form of 'self-regulation' is needed and this can be best achieved, according to his present thinking, by the appointment of 'audit committees' controlled by independent non-executive directors.

6. There has been some support for increasing the use of non-executive directors on a voluntary basis. In 1982 PRO NED (Promotion of Non-Executive Directors) was set up. Sponsored by the CBI, Bank of England and City, it seeks to encourage the appointment of non-executives and gives assistance in finding suitable candidates. But until recently Sir Brandon has received little support for compulsory requirements. In 1981 the Department of Trade consulted outside industrial and professional opinion on Sir Brandon's proposals and the balance of the replies was firmly opposed. Again, in 1983, when DTI consulted outside opinion on the EC's proposed Fifth Company Law Directive, an essential feature of which is the compulsory appointment of non-executive directors, most opinion was firmly opposed.

7. Since 1983 there has been some movement in favour of the appointment of audit committees (which in turn require the appointment of non-executive directors) while Sir John Hoskyns of the Institute of Directors recently informed the DTI that the Institute regarded legislation to require non-executive directors as virtually inevitable. In addition there have been the amendments to the Banking Bill.

8. Sir Brandon wrote to Mr Channon on 16 February with the latest outline of his Bill (a copy of which is attached) to which a reply will be sent shortly. The most important proposal is that the Stock Exchange would require, as a condition of listing, that companies should appoint audit committees. As the Stock Exchange listing requirements are matters of public law - because of EC Directives - the government would be directly involved. The proposals for the preparation of estimates as to the future course of a company's business need to be considered in relation to the new civil liability for 'wrongful trading' (section 214 , Insolvency Act 1986), as well as to the older criminal offence of fraudulent trading (section 213, Insolvency Act 1986).

9. While the appointment of non-executive directors has not kept companies out of trouble it would be mistaken to argue that they serve no useful purpose. On the other hand, as Sir Brandon himself recognises their more widespread appointment would not be a panacea.

A

A. DEBATE ON NON-EXECUTIVE DIRECTORS/AUDIT COMMITTEES

REPORT STAGE: BANKING BILL 19 FEBRUARY

19 FEBRUARY 1987

BANKING BILL

Col 1125

Col 1126

Clause 91

NON-EXECUTIVE DIRECTORS

Mr. Nelson: I beg to move amendment No. 57, in page 68, line 36, leave out clause 91.

Mr. Deputy Speaker: With this it will be convenient to take the following amendments: No. 58, in page 69, line 5, leave out clause 92.

No. 61, in schedule 3, page 80, line 31, at end insert—

Col 1126

'*Composition of board of directors*

2A. In the case of an institution incorporated in the United Kingdom the directors include such number (if any) of directors without executive responsibility for the management of its business as the Bank considers appropriate having regard to the circumstances of the institution and the nature and scale of its operations.

No. 62, in page 81, line 19, leave out second 'and' insert '(7A)'.

No. 62A, in page 81, line 22, at end insert

'and in determining whether those systems are adequate the Bank shall have regard to the functions and responsibilities in respect of them of any such directors of the institution as are mentioned in paragraph 2A above.'.

No. 63, in page 81, line 22, at end insert

'and in determining whether those systems are adequate the Bank shall have regard to the functions and responsibilities in respect of them of any such directors of the institution as are mentioned in paragraph 2A above and the formal working relationships established between such directors and the auditor or auditors'.

Mr. Nelson: Amendments Nos. 57 and 58 seek to take out of the Bill those amendments which were passed during the Committee stage which provided for the statutory requirement that there should be a minimum number of non-executive directors on the board of the United Kingdom registered banks and that they should form themselves into a majority composition of audit committees with specific remits of considering the financial control structures, the scope of remuneration of auditors, and the compliance of the bank concerned with the probative provisions of this legislation.

In Committee the Economic Secretary expressed some support for the sentiments behind the representations that were made at that time and, indeed, for much of the intention of those amendments. At the same time the Bank of England itself issued a circular to banks, seeking their comments on its proposals for audit committees, involving inevitably a substantial representation of non-executive directors. Ernst and Whinney, in its interesting guide to directors entitled "Bank Audit Committees", said:

> "A recent study of quoted companies by the Bank of England has shown that on average one in three directors is now non-executive and of 60 per cent. of the companies examined, the board included three or more non-executive directors."

It was always recognised that the best practices of many joint stock banks would not be affected by the amendments. We were seeking to ensure that in the medium sized and smaller banks, and in some more questionable banking concerns, there was a genuine independent and non-executive element which would act as a check not just on the credit analysis and policies and on the audit and accounting requirements but also on the extent to which the bank complied with the probing provisions of the legislation.

With the background of the Johnson Matthey bank collapse it is fair to point out that if that representation had been there, and if the right questions had been asked at the time, we might not have had the problems which subsequently arose. As we are in the business of depositor protection with this legislation, I believe — and I am delighted that the Committee concurred at the time — that there was and remains a strong case to be made for non-executive directors in the banking sector, apart from the arguments that could be strongly adduced for their election elsewhere in the commercial sector.

[Mr. Nelson]

I should like to pay tribute to my hon. Friends the Members for Harrow, East (Mr. Dykes) and for Suffolk, South (Mr. Yeo) for their support in drafting the amendments and also for their resolute support in Committees. Standing Committee can play a useful role on non-party matters, admittedly at the margins, in tightening up the provisions of the legislation and enhancing them as we have done.

My hon. Friend the Economic Secretary was good enough to point out in Committee that while he was unable to accept the amendments as tabled, he would try to import the concept of non-executive directors and seek on Report to go beyond that in regard to their responsibilities. He pointed out—and I accepted then and subsequently—that clauses 91 and 92 would be an improper and impracticable burden to place on the banking sector, and particularly on small banks where it might not be appropriate to have such a large minimum number of non-executive directors. He referred to subsidiary banks where the holding banks might already have non-executive director representation.

For some small, authorised institutions, which, although banks, are largely inactive, and are not trading substantially, it would be a costly and not very effective means of securing a check on the audit activities and the directorial responsibilities of the boards. For that reason I discussed with my hon. Friend the Economic Secretary ways in which his supportive sentiments and the intention of the Committee might be satisfied. The result of those discussions is the amendments which have been tabled.

The amendments seek to provide a presumption that there shall be non-executive directors on the boards of banks but that the Governor of the Bank of England shall retain the discretion to waive that requirement, or vary it, according to the circumstances of individual banks. Amendment No. 61 will meet that need and add to schedule 3 a specific provision on the composition of boards of directors which can mean nothing other than that they shall have non-executive directors. I think I am right in saying that it will for the first time import into company law the concept of non-executive directors. While it is not a departure from the unitary board system and the individual and collective responsibility of all directors for the operations of the company, it will for the first time recognise and identify in law non-executive directors in the banking system. To that extent, it will be a useful paving amendment which may be built on in other parts of company law.

Many people may reasonably say that it is not sufficient to have non-executive directors and to let them organically determine in each bank or collectively what function they will have. Hon. Members will be aware that the character and the role of non-executive directors can vary enormously between companies or between banks. There is little one can do about non-executive directorships being appointments of patronage of the chairman, the chief executive or a controlling shareholder. Inevitably there will be an element of jobs for the boys in the appointment of non-executive directors of banks, or former employees may stay on in a sinecure capacity. However, they will have a non-executive function in that they will not be involved in the day to day business of the company.

An inevitable problem is that non-executive directors will go along to a large extent with the views, policies and practices of the rest of the executive board. On the other hand, hon. Members will be aware of many companies, particularly public companies, where the non-executive directors guard their independence and their objectivity zealously and where the executive members of the board and members of the company have a keen interest in maintaining the objectivity, independence and impartiality of the non-executive directors. Executive directors benefit from the non-executive directors asking the right questions at the right time, and indeed asking difficult questions at a difficult time. In that way one can perhaps stave off problems that might otherwise arise. Most companies which use the practice have done so to their advantage.

To try to answer the question as to how the role of non-executive directors of banks should evolve, amendment No. 62A was tabled. It attaches to a later part of schedule 3 additional words which will ensure that non-executive directors have specific responsibility for the accounting activities of boards of directors. While they may envolve different means of fulfilling that responsibility in each bank, the significant point about amendment No. 62A is that it refers back to paragraph 2A in amendment No. 61, which directly links the responsibilities of the non-executive directors for audit and accounting to their identity and to the presumption that they must be on the boards referred to in paragraph 2A of schedule 3.

That linkage is a very important adjunct to the initial amendment. The result is that amendment No. 62A can mean nothing other than that the non-executive directors are expected to form themselves into an audit committee. I understand that it is difficult and impractical to import audit committees into law at the moment. My hon. Friend the Member for Kensington (Sir B. Rhys Williams), who has been such a champion of this cause over many years, and I have sought to do this—he through his Bills and I in the amendments moved in Committee. To the extent that it is practical in law, I think it is provided in amendment 62A.

8 pm

However, there is a problem with this. Much will depend on how the banks, and the Bank of England in particular, respond to the rather wide phraseology of the two amendments, particularly No. 62A. The amendments would have the effect of taking out the advances already made in Committee and substituting these changes, but first I want to be satisfied—and I sincerely hope that my hon. Friend the Economic Secretary may be able to satisfy me—that the Bank of England itself accepts an obligation, apart from the circular which it has already issued, to follow through on the content of these amendments and to insist that where there are non-executive directors, and in many boards where there are not, there will be audit committees and they will have defined minimum remits to fulfil and a certain degree of accountability, as well as some penalty that they can impose if what they recommend is not followed. Some discussions may already have taken place, and I hope that my hon. Friend will be able to give us as full an assurance as possible concerning the intentions of the Bank of England in this respect.

If that can be done, and, if I and other hon. Members can be satisfied that the Bank of England really intends to use the provisions to ensure a much wider representation of non-executive directors and that they do a job of work

within the banks, the House and our Committee will have achieved something and it will be an important landmark and an important marker for the future.

Mr. Dykes: I wish to be as brief as possible in following my hon. Friend the Member for Chichester (Mr. Nelson) with a few remarks about this cluster of amendments in his name and the names of my hon. Friend the Member for Suffolk, South (Mr. Yeo) and myself. I fully endorse what my hon. Friend said. He was remarkably skilful in keeping his speech slightly shorter than it might have been, bearing in mind that he is the principal sponsor, and quite a number of other points could have been made. I understand the reason for that and, perhaps rather agreeably for Thursday night, we have reached these important amendments somewhat earlier than might have been expected when the Committee stage began.

What has resulted from the discussions in Committee, from subsequent discussions that may have taken place informally and from the amendments on the Amendment Paper, represents what we as sponsors would suggest is the best balance of all the complex considerations in a very important piece of reform. Without getting too carried away, and with no disrespect to the Government's other changes in the Bill, which have commanded widespread support, we suggest that this is perhaps the most important part of the Bill in terms of additions to it.

The history of the Bill, as was explained on Second Reading and in Committee, stemmed from a series of unfortunate accidents in respect of one institution. It was therefore very much a repitition of the 1979 Act, but with the abolition of the two entities, which were banks or quasi-banks, making them into one in terms of any supervision or surveillance that was being constructed or repeated from the previous statute. This and the other three or four significant changes made by the Government, are the important changes to the Bill.

In putting forward these amendments tonight we very much hope that the Government and my hon. Friend the Minister will be able to accept what has been suggested by way of a compromise. As my hon. Friend the Member for Chichester said, we do this without in any way yielding or ceding the basic elements of the strategy that was being constructed all the way through my hon. Friend's speech in Committee when the then new clauses 10 and 11 were being promoted by him and others, including myself, because of the current circumstances and difficulties and the need to increase the supervision of institutions where the public's wealth, welfare, financial interest and, indeed, moral interest to some extent, are involved.

This is also carrying out an essential reform, whatever way it may work out in detail, depending on the decision of the House tonight and the Government's reaction to these amendments, which represent something of a compromise on our part. It is a significant reform, going back to what my hon. Friend the Member for Kensington (Sir B. Rhys Williams) has been trying to do over many years, earning the plaudits and the tributes of Members of the House and people outside in so doing, in respect of companies in general. For the moment I think that we can with justification concede that there is a significant difference with financial institutions and banks and other corporate entities may be left for another day, depending on the experience of this legislation if these amendments are accepted by the House.

During the debates on these issues in Committee I was struck by the fact that my hon. Friend the Minister was in difficulties. We recognised that and could understand and sympathise with him, but unless I misrepresent him —and it is always easy to do this when one is guessing —he was nevertheless anxious to try to help if possible. However, we have to admit to ourselves as well as to the House that the dropping of what are now clauses 91 and 92, as amended in Committee in favour of what we now deem to be something that might have a better chance of getting through the House, is a major step for us as sponsors of the amendments.

We hope that this will be an inducement to the House to look favourably upon our compromise suggestions and also that it will generate the support of the Government. We are attempting to meet my hon. Friend the Minister's objections and worries in Committee that we were perhaps in phraseological terms trying to overdo things and construct too tight a legislative provision, but none the less to achieve our objectives in this legislative attempt to get non-executive directors inserted for the first time into bank boards.

My hon. Friend the Member for Chichester referred to the lapsing of the specific reference to audit committees. I agree strongly with him that our substitute suggestion, amendment No. 62A, is a helpful way of our putting this forward to the House and trying to meet the Minister's worry that, textually, we were overdoing it, exaggerating and perhaps creating difficulties. Perhaps we can all agree —I say this tentatively—that the essential requirements and objectives of the original amendments in Committee can be met without too tight a legislative and textual end result in the actual words.

This would fit in very well with what was said in the Bank of England's consultative paper, which appeared perhaps somewhat miraculously, and certainly very interestingly in terms of its timing, when the Committee stage was drawing to an end. In its document the Bank of England endorsed in strong terms the idea, referred to indirectly and perhaps somewhat vaguely, for obvious reasons, in amendment No. 62A, but none the less with great emphasis, that the audit committee should have specific and clear duties, and that even if these duties were not put into legislation at this stage — although by implication the Bank of England's presenting letter had legislation in mind as a background possibility — depending on how these were to function first in a non-legislative form, perhaps later they would come into the legislation. I see that as the implication of this whole exercise even if, for obvious reasons, certain people, including the Bank of England, will wish to deny that now.

I refer very quickly to page 10 of the consultative paper and the references to what the members of audit committees should do. I hope that under our suggested compromise amendments my hon. Friend the Minister can react to these ideas yet again to reassure us that that is the whole direction of the Government's thinking and policy in line with the Bank of England's ideas and suggestions, even if there is no specific legislative reference now, and I say that with great emphasis.

Page 10, paragraph 5.5 of the document relates to the functions of committee members. With heavy emphasis, the Bank of England document states:

"The directors appointed to the audit committee should be able and willing to accept the related responsibilitis and should have relevant experience and skills. All members of the

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committee, including its chairman, should be independent of financial management and of any responsibility for the accounting, internal control and auditing functions in the bank and be free from any relationship that could interfere, or be seen to interfere, with their objectivity and the exercise of their individual independent judgment."

I shall not continue to quote from paragraphs 5.6 and 5.7 because I do not want to weary the House. However, if hon. Members read those paragraphs they will acquaint themselves with the Bank of England's suggestions. The Bank of England's suggestions felicitously fit in with our "compromise" amendments and the suggestions to which my hon. Friend the Member for Chichester referred, which are revealed in the booklet circulated by Ernst and Whinney. Unless I have overlooked something in my mail recently, I believe that that booklet is the only publication that hon. Members have received from any firm of accountants. I hope that I shall not be regarded as vulgarly promoting one particular firm. I do not know that firm personally, although I believe that it is famous.

My hon. Friend the Member for Richmond and Barnes (Mr. Hanley) is familiar with and, I believe, is a distinguished member of, the accounting profession. I believe that he has declared his interest in this matter although not of course meaning in Ernst and Whinney. My hon. Friend will agree that Ernst and Whinney's document "Bank Audit Committees — A Guide for Directors" implies that there is ground for legislation on these matters. Although the debate is still raging, Ernst and Whinney sets out in helpful, precise, elaborate detail those functions which the firm believes audit committees and their members should perform. I refer to the helpful suggestions made in the Ernst and Whinney document on pages 11, 12 and 13. On pages 14 and 15 Ernst and Whinney describe the comprehensive management functions that should be found in any corporate organisation, including banks. Within that list of functions, reference is made to audit committee functions.

Progress is thus being made. The suggestions made by the Bank of England and Ernst and Whinney are encapsulated in the amendments. However, as my hon. Friend the Member for Chichester said, giving up the purposes of clauses 91 and 92 is a big step. I do not know whether we will have the agreement of the House in this matter, and the amendments do not have the effect of the amendments that were originally proposed in Committee. It is incumbent upon the Government—and I shall be interested to learn the reaction of the Opposition if they choose to intervene in the debate—to tell us their views on these matters and the way in which they can accommodate the amendments.

I want to make a point that relates to the atmospherics that were evident in Committee. I want also to echo what was said by my hon. Friend the Member for Chichester and pay tribute to the way in which my hon. Friend the Economic Secretary has tried to be helpful. This has been appreciated. None the less, in Committee we were struck by the paradoxes that we have to face. On occasions when there is no party political implication and we are debating legislation that does not raise a party battle, but arises from a general consensus in that an emergency has produced a need to update legislation, to tighten supervision and to abolish the distinction between licensed deposit takers and banks — without the conventional political dog fighting that sometimes prevails—there is none the less a reluctance by civil servants to accept changes in legislation. Civil servants, rather than Ministers, are reluctant to make changes that will reinforce and improve legislation. I believe that these changes would not cause any intrinsic difficulty for the Government, and that point transcends the political nature of the party in government.

8.15 pm

I do not believe that other European legislatures have the built-in automatic difficulties that face any Government here. I hope that I shall not annoy any of my colleagues by making that point. However, it is a pity that a macho stance must be adopted in Committee. I trust that I shall not annoy my hon. Friend the Economic Secretary when I say that there is an idea that if a concession is made, that will produce a tearful reaction. I do not mean that literally, but metaphorically. That reaction is often unnecessary. If a general feeling wells up in Committee or on Second Reading that an addition, a reinforcement, a piece of legislative material or an amendment can be brought in significantly to improve a measure, or a marginal part of a measure, there is an over-reaction.

Why is that so? We could have a great deal of philosophical discussion about that, but not tonight. However, it is a pity that that repetitive over-reaction element in legislative debate occurs in Committee. That is less important as a consideration and as a point of hesitation about the meaningfulness of our debates on the Floor of the House. It is much more obvious then that party political dog fights will occur. However, that is not necessary in Committee, particularly when we are discussion banking measures.

I hope that I have not been too long winded. I have made that point deliberately at some length and have probably risked the wrath of hon. Members in so doing. I hold this institution very dear and believe that by and large it does a good job in promoting legislation, but all too often in debate there is a reluctance to change legislation. Perhaps, to make ourselves feel better, we can point the finger for that reluctance at the civil servants rather than at Ministers.

Mr. Tim Yeo (Suffolk, South): My hon. Friend the Member for Harrow, East (Mr. Dykes) raised an interesting point at the end of his speech. If time permitted I would like to pursue that, but as it does not I will merely say that, broadly speaking, I concur with him.

I pay tribute to my hon. Friend the Member for Chichester (Mr. Nelson) and to my hon. Friend the Member for Harrow, East. They raised amendments on this matter in Committee and voted for them. That action distinguished them from other hon. Members. My hon. Friend the Member for Chichester has led with great skill and determination the campaign to make the changes in the Bill. I am glad that since the Committee stage was concluded he has been able to negotiate an acceptable compromise although naturally I am disappointed that we do not have in the Bill the specific clauses that were agreed in Committee. Nevertheless, we have taken a considerable step forward.

It is especially appropriate at a time when self-regulation is under a certain amount of criticism that we should be strengthening and making specific reference to the role on non-executive directors. Only recently in the banking world self-regulation has shown that it can operate successfully and swiftly. In the aftermath of the

Guinness affair, top management has been replaced in what was considered to be one of the most powerful merchant banks. That occurred with a swiftness which could not have been achieved under a different system. Perhaps that will lead in due course to the consideration of non-executive directors in stockbroking firms. Again, recent events may suggest that that would be a desirable innovation.

It is very important in consideration of the amendments, that we should not overstate the implications of the amendments or the Bill. There is nothing that we can do through legislation that will eliminate incompetence, imprudence and fraud. Those are facts of life. They are regrettable, but they exist. However, we can establish a good supervisory system and regulatory framework that will detect those abuses quickly.

The innovative nature of today's financial markets is such that new instruments will always be devised, the use of which will test the technical skill of the regulators by seeing that banking in particular is conducted in a proper fashion. We only have to note the enormous growth in the swaps market and the acknowledgment in the document produced jointly by the Bank of England and the Federal authorities in America that they are so far unable to produce an acceptable definition of the weight to attach to certain instruments, including some of the new swaps, to see the truth of that. That is an example of a difficulty that will always exist about trying to regulate the banking business.

It comes back to the probity, integrity and independence of the board of directors. The provisions in this group of amendments greatly strengthen both the independence and, I hope, the probity of those directors. The role of good non-executive directors will be crucial in ensuring that banks will conduct their business properly. The establishment of audit committees would also make a substantial contribution.

When the matter of non-executive directors was raised in the Standing Committee the Minister said that there might be some problem about definition because we were introducing into law a concept that was not previously recognised. To illustrate that, I shall cite a conversation that I had with the chairman of one of the big four clearing banks. It was a private conversation so I shall not identify him. I asked him how he saw his role and he said he regarded it as being that of a full-time non-executive. On initial reflection, that concept presents a paradox. He went on to explain that he believed his job was to represent the outside interests of the bank — the interests of the depositors and the shareholders as opposed, perhaps, to the interests of the management.

When someone in a prominent position in banking describes himself as a full-time non-executive, one is forcefully reminded of the problems of definition, because I rather suspect that those of us who have put our name to these amendments look upon a non-executive as someone who, by definition, is not full-time. Of course he may be paid for his non-executive duties and it is proper that he should be, but his full-time work or most of his work is done away from the institution in which he is a non-executive director. I should be interested to hear whether my hon. Friend the Minister has had any more thoughts about a definition in the period since the Committee concluded its debates.

I echo a good point made by my hon. Friend the Member for Chichester (Mr. Nelson). I hope that since we have had to give up a specific reference to a minimum number of non-executive directors being appointed and a specific reference to audit committees—because neither of those will now appear in the Bill—that the Minister and the Bank of England will make clear publicly that they regard the inclusion of such directors as a matter of the greatest importance for informing their judgment about the suitability of an authorised or potentially authorised institution to be a bank. A public statement of the bank's policy and of the Government's policy about those points would be of immense value. I hope that the statement will refer not only to the matter about the number of non-executive directors, but that it will also make specific reference to the role that they could play in relation to audit committees.

Mr. Cash: I congratulate my hon. Friends on their speeches. Those congratulations are more than justified, given the circumstances in which the amendments were moved in Committee and the way in which my hon. Friends have persevered to achieve as much as they have. As my hon. Friend the Member for Suffolk, South (Mr. Yeo) said, they have not got everything that they wanted. However, that in no way diminishes the importance of the step that has been taken.

I have and will continue to have some reservations about creating what could turn out to be a rather top heavy audit provision in relation to either banking legislation or companies legislation generally, of which banking is a part. The boards of directors of banks are governed by the Companies Acts every bit as much as directors in other companies. In the field of the non-executive director our minds are drawn to the question of independence. That goes back to the matter that we discussed during the passage of the Financial Services Act 1986, the importance of which has become a feature of discussions in Parliament over the last few years.

Against the background of the scandals and the misfeasance that have occurred recently, some of which were serious and some of which must not be exaggerated, the notion of independence, of a watch dog, a non-executive director, is increasingly becoming a matter of policy. However, at the moment it has not been explained as such by or on behalf of the Government. The notion is becoming increasingly accepted and those of us who serve on Committees and who have maintained an active interest in financial services, in banking and in the troubles that have occurred in the field of company law, are increasingly driven to the view that the independent watchdog, the non-executive director, has the function of maintaining a fiduciary relationship with the members of the company. That role is of paramount importance.

I think that section 235 of the Companies Act 1985 has provisions which require that employees should be fully informed and involved in the policy making of a company. In banks and in other companies there are also people who are called shareholders, and they have a vast interest in what is done in their name. The object of the audit committee proposal and the idea of a non-executive director are to enhance the role of fiduciary relationship which, I regret to say, and I know that hon. Members will agree, has been under a considerable strain recently in certain quarters.

It seems to me that we need not merely a total and thorough investigation of the financial aspects of banking or of companies. That is well exemplified in this interesting

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paper produced by Ernst and Whinney and entitled "Bank Audit Committees — A Guide for Directors". We also need an opportunity to look at the role of the board and the manner in which it exercises its fiduciary relationship. In addition to the provisions in the Bill, I should like to see provisions that are more explicitly defined and aimed at directing shareholders.

There should be a shareholders' committee to complement the role of the non-executive director. That would enable a balance to be struck between institutional investors and the small shareholder. It is a fact of present day life that in wider share ownership, the explosion in the ownership of shares throughout Britain — whether in banking or in other fields such as British Telecom or British Gas — a gap has emerged which needs to be filled. It could be filled by a shareholders' committee along the lines suggested in my Protection of Shareholders Bill and some re-definition of the role of auditor, accountant, solicitor and company secretary. That is a perfectly reasonable proposition and would provide a means whereby non-executive directors and the audit committee, which I hope will eventually come into being, will be supplemented so that they know that when things go wrong they will have an opportunity, either individually or jointly, to turn to that committee. After all, the committee would represent the members of a company, whether they be institutional investors or small shareholders, and they have an absolute right to know what is going on. If there are breaches of criminal law, fiduciary relationship company or banking legislation, they have the right to be informed about what is happening. I make no apology if that is regarded as a novel idea; it complements the arrangements that my hon. Friends have introduced, and on which I congratulate them. They have taken a great step forward.

Mr. Dykes: I am sorry to come back to a point that puzzled me earlier. I am not clear why my hon. Friend was so adamantly against the new clauses that we introduced in Committee and which, I am glad to see, he is now supporting. Perhaps he could explain that to the House.

8.30 pm

Mr. Cash: Yes, I can do so easily, although adamant is not the word that I would have used. I was not persuaded at that time of their value. However, having heard the brilliant speech of my hon. Friend the Member for Harrow, East (Mr. Dykes), who could fail to be converted by the logic and emotion with which he addressed the House for about 20 minutes? Therefore, in the light of what has been discussed, I hope that what has been put forward is accepted. I want to take this opportunity to congratulate my hon. Friend the Member for Kensington (Sir B. Rhys Williams) on his determined campaign since 1969, and thank him for all that he has done in this area.

Mr. Hanley: I, too, congratulate my hon. Friend the Member for Kensington (Sir B. Rhys Williams) on his almost unique campaign. It is 17 years since he first introduced his Bill on audit committees. He has introduced such a Bill every year in this House, and when he was in the European Parliament he took every opportunity to try to introduce it there also. Few people have such determination for a cause that seems unattractive at first sight, at least on voting intentions, but which is, nevertheless right. I have spoken to his Bills and been a supporter of them since I came to Parliament. Therefore, when my hon. Friend the Member for Chichester (Mr. Nelson) sought to table new clauses 10 and 11 for the Committee stage, I leapt up to support them. It was with great frustration that I found that I was not a member of the Committee. However, I added my name to those amendments because I believed that they were the right way forward.

I was surprised when, through the courage of those who stuck to their convictions, those clauses became part of the Bill on Report. I was not only surprised but, in a way, I was bored because, for the first time in a substantive statute, my hon. Friend the Member for Kensington had seen the birth of the child that he had gestated 17 long years ago. I believe that that is longer than whales, elephants, human beings or any known living creature.

However, there was no doubt that my hon. Friend the Economic Secretary had to take advice and to suggest, perhaps in a mood of compromise, clauses that would go some way towards meeting the national mood of greater control over corporate institutions, while seeking a successful and practical method of achieving that.

I have already declared my interest as the parliamentary adviser to the Institute of Chartered Accountants in England and Wales. On behalf of all accountants, I thank the many members of the Committee who have paid the most marvellous advertising service to the firm of Ernst and Whinney for its excellent booklet. If any firm has been rewarded for its skill and effort in producing such information, Ernst and Whinney has tonight.

I should mention my hon. Friend the Member for Stafford (Mr. Cash). I may be wrong in this detail, but I believe that his grandfather was a founding father of the Institute of Chartered Accountants, and must have known the founding father of Ernst and Whinney. One can imagine those two august gentleman, in Victorian days, meeting at the origins of the institute. Little would they have realised that the grandson of one——

Mr. Cash: The great grandson.

Mr. Hanley: Little would they have realised that the great grandson of one would advertise the eventual product of the other in this House.

The Institute of Chartered Accountants believes that although those clauses were supportive of the underlying philosophy of the initiatives, they were not practical and would not achieve their objectives. The issues raised by both clauses were considered widely by member firms in the institute and also by the committees of the institute that deal with such matters. In the light of the recently issued Bank of England consultative paper on the role of audit committees, which has already been referred to, and in the light of the response of the Department of Trade and Industry's consultative documents on the implementation of the eighth directive, these matters were given a fair airing.

It was thought that the institute should submit its advice to the Treasury. It did so in October 1985 and in February of this year when it sent a letter to the Treasury stating that the mandatory requirement for three directors could be over-onerous on certain banks for the simple reason that the size of the bank was in no way taken into consideration in the drafting of the original clause. One

could possibly agree to a mandatory requirement for banks above a certain size, but one should allow banks under a certain size to appoint just one non-executive director to the board. The requirements created by the original new clause 10, that all authorised institutions had to retain at least three non- executive directors who would be wholly independent, took no account not only of the size, but of other factors and of the special situations of groups in which there might be a number of authorised institutions.

The institute considered that the appointment of non-executive directors should take account of the size of the bank. It also considered that the Bank of England should establish with the prospective authorised institutions, when authorisation was sought, the development and size of that authorised institution at that time. For those reasons, the imposition of the statutory minimum of three non-executive directors appeared inappropriate. There has been some discussion in the City as to where one could find the appropriate individuals to fill the places that would be created by the statute.

In any event, the institute pointed out to the Treasury that it saw good reason for the retention of a least one non-executive director in all authorised institutions. Indeed, that is the essence of the amendments that have been moved by my hon. Friend the Member for Chichester (Mr. Nelson).

The institute felt that the function and the role of the non-executive director required careful definition. The criteria expressed in the clauses appeared to restrict it, and the Bill already gave the Bank of England the right to establish that the directors of the institutions were fit and proper persons before granting authorisation. Therefore, the institute felt that it would probably be appropriate to leave with the Bank of England the responsibility for determining the suitability, or otherwise, of the proposed non-executive directors. That is what the institute recommended earlier this month, and I am glad that the compromise amendments have been tailored accordingly. I am also glad that the institute's advice was properly taken into account.

Although the original amendments will not see the light of day in the Bill as it passes to another place, this is a momentous occasion. My hon. Friend the Member for Kensington should regard this as a red letter day, not only in his life but in the life of regulation over institutions—in this case over banks, but perhaps, in future, over companies. However, it is a shame—I am sure that my hon. Friend did not expect this—that the first gleam of light in the history of audit committees and statutes should be at the hands of the Treasury and not those of the Department of Trade and Industry.

It is remarkable that the Treasury should be so understanding of the need for this type of supervisory body. Perhaps the Department of Trade and Industry, which often prides itself as the Department of innovation, will look to the Treasury, which it often regards as a body of people who do not have the vision of technical innovation and advance which it sponsors, and learn from this Treasury legislation. I hope that the Treasury, in its rules and guidance, will set out the detailed provisions that my hon. Friend the Member for Kensington has mentioned on many occasions.

Audit committees are required by companies quoted on the New York stock exchange. Therefore, over many years, they have served not only the institutions that they have helped but, more important, the shareholders in them. The practicalities of audit committees are proven. In the United States, they have lasted for many years. The fact that these new clauses will lead to this type of audit committee is an important moment in the life of the House.

Mr. Nelson: My hon. Friend made an interesting and important point — it was referred to in Committee — about listing requirements on the New York stock exchange. I shall be interested in his views, not only as an hon. Member but in his advisory capacity to the institute —this matter goes slightly beyond the remit of the Bill —about whether he and the institute would favour such a requirement here. If, in the near future, this provision is not extended in company law more generally, many people will consider that there is an urgent and compelling case for the stock exchange to provide a similar listing requirement.

Mr. Hanley: My hon. Friend spoke forcefully in Committee about the advantages and, indeed, the disadvantages of audit committees. The point that he raised is relevant to these amendments. What will be the influence of the amendments upon other financial institutions? The Institute of Chartered Accountants in England and Wales has not this year stated an official view on the point, but in the past it has issued documentation setting out the role of audit committees, their advantages and disadvantages, and how major companies can set them up.

It is interesting that, in the one thousandth edition of the official journal of the Institute of Chartered Accountants, named "Accountancy", the editorial should be a cry for audit committees for major companies. Indeed, not long after, my hon. Friend the Member for Kensington introduced his annual Bill, to the general acclaim of those who are fully conversant with the need for accountability in the City, and it was welcomed by many chartered accountants. It will be difficult for some authorised institutions to find an audit committee of, let us say, three, four or five people.

8.45 pm

The amendments are practical. Because the Bank of England is obliged to satisfy itself that an institution's board has sufficient non-executive representation according to its size, with suitably defined roles, before it can be authorised, the right compromise has been reached. I am certain that the Institute of Chartered Accountants is happy with the final result and would offer its congratulations not only to the founding father of the audit committee, my hon. Friend the Member for Kensington, but to my hon. Friend the Economic Secretary. With his usual wisdom, my hon. Friend the Economic Secretary has found a compromise that will be practical, helpful and, ultimately, of benefit to those who invest in banks, and surely that must be the vast majority of the nation.

Sir Brandon Rhys Williams (Kensington): The clauses may prove to be an important aspect of the Bill. Therefore, the House is justified in giving the matter a few more minutes. I take the opportunity of thanking my hon. Friends, in particular my hon. Friend the Member for Richmond and Barnes (Mr. Hanley), for their kind

[Sir Brandon Rhys Williams]

references to my long-standing campaign to improve the ways in which the executives of companies can be supervised in the course of their work.

I must correct one point that my hon. Friend the Member for Richmond and Barnes mentioned. I do not think that I introduced the expression "audit committee" into my series of proposals until as recently as 1976. With my first Bill I tried to bring into statute the expression "management audit". The management audit was to be instituted by a shareholders' committee, as I envisaged it, very much along the lines of the Bill that my hon. Friend the Member for Stafford (Mr. Cash) has just brought in, which certainly deserves consideration by the House.

Self-regulation is part of Government policy. We must look to the Government to come forward with specific measures to enhance the way in which self-regulation works in banks and in public companies generally. Obviously, self-regulation is a matter for shareholders' natural prudence; but there is a special reason why it goes a little wider than simply protecting the shareholders' interests, and that is the enormous privilege of limited liability. If shareholders are able to rely on that serious concession, they have a duty to see that companies, or banks, as in this case, are managed in a competent and efficient manner. It is a matter of public interest and shareholders' duty.

How do shareholders exercise supervision? Over the past century or more, businesses have become so complex and so large that it is not possible for shareholders to get an accurate conception of what is being done by the executives who are appointed to make use of their assets. Different solutions have been found in various countries over the course of time. The German solution of setting up a separate supervisory board to watch, on a permanent basis, what the executive board is doing, obviously has many advantages, but that is not the way in which this country has developed its company law. While the Germans were evolving a concept of the supervisory board, we were placing more reliance on auditors. In the nineteenth century, it first became obligatory for companies to have an independent audit.

We have retained the concept of the unitary board, but, for some reason, in British company practice, it does not seem to be operating as well as we should like. In the United States and Canada, the concept of the unitary board has been retained, but there has been a significant development there that we have not yet followed. Of course, American banks are closely controlled by all kinds of provisions that have not been introduced here—I do not for one moment suggest that they should be—but the practice in America has been to develop the audit committee. It is a pity that we have not moved much faster in that direction. I blame the DTI for its immobilism in respect of the concept of the audit committee. Year upon year, it comes to the House to amend our company law and to add enormously to the scope of it, to add to the power of inspectors, panels, boards, the police and whoever else can bring pressure to bear on companies from outside. That is not self-regulation—one may call it what one will—but outside pressures on companies are not proving to be effective. Thus, we find ourselves in a highly unsatisfactory situation. It is not possible to open the newspapers without reading about some new, unwelcome or unsavoury development in companies and banks.

This is the Department of Trade and Industry's silly triumph. It has resisted the concept of self-regulation although that is the direction in which we ought to go. I am extremely glad that hon. Members on both sides of the House share my opinion about that. British practice in the supervision of the executives of major companies is too loose and, as one would expect, the executive elements become either too enthusiastic and go much too far or they become sluggish, inefficient and resistant to change and fail to take advantage of new opportunities.

In the case of the scandals that have upset us with regard to the banks—in particular Johnson Matthey, Morgan Grenfell and others, very fine and reputable institutions where things went rapidly wrong—one has to ask what the auditors and the directors were doing by allowing those situations to develop and become so disastrously out of hand. In those cases, I do not believe that the auditors or the directors were necessarily to blame. What is wrong is the system, and that is what we are dealing with in these clauses.

We must freshen up our ideas about the responsibilities of auditors and the way that we call upon them to work, and we must also freshen up our ideas about the responsibilities of directors.

I strongly recommend anybody who is interested in the subject to take the trouble to read the speeches that were made on the last morning in Standing Committee when my hon. Friends—in particular my hon. Friend the Member for Chichester (Mr. Nelson)—forced the Committee to take note of their views on the way in which the Banking Bill should be amended. The debate contained many important comments that well deserve study, and I hope that they will indeed be widely studied. My hon. Friends deserve well of their House for the courage and persistence in insisting that the Committee should take note of their views.

Over the last 100 years there has been a change in the concept of the director in British company law. If one goes back to the 1856 Act—one of the first really important measures that this House introduced in regard to company law—it was then axiomatic that the directors were all independent. The idea of their taking executive responsibilities is virtually excluded by the terms of that Act, because that was not the practice in those days. It is only in the Board of Trade Order 1906 that one finds the concept of the managing director beginning to be accepted. The managing director is really a one-man committee of the supervisory board that is running the business.

From there we have moved on and have now reached the stage where hon. Members say that to introduce into company law the idea of the non-executive director, or the independent director, would be an innovation. But the independent director is not an innovation; he is a relic, who is gradually disappearing. When one examines what those who claim to be non-executive directors are doing, one finds that they may be full-time officers of the company, or that they are serving the executives or the business in various functions and are not acting in a supervisory capacity at all. Because they are so involved in the management of the business they are unable to exercise supervisory functions. Therefore the supervisory role of the directors is going by default.

I do not accept the idea — which I am afraid emanates from the Department of Trade and industry— that if we refer to non-executive directors or independent directors this will be a catastrophic change and a great new intrusion into company law. It is quite the reverse. It is simply holding from further decline the status of the supervisory director.

How are we, then, to proceed, and in particular how should we proceed with regard to banks? I pay a considerable and warm tribute to the Bank of Englend for producing its consultative paper last month on the role of audit committees in banks. It is an excellent document. It does not mention my 1985 Bill; it refers only to my 1983 Bill, which shows just how little effect Back Benchers can have, even on those who are most supposed to know the views of this House. But never mind. I pay tribute to this excellent paper. However, it is simply a matter of exhortation.

The bank is asking the various institutions in the City to do what they think is right and to appoint an audit committee. I am afraid that if we rely on exhortation, the consequence normally is that all right-minded people who are efficient and run decently managed companies will do what they have been asked to—if they are not doing it already, while those who one most wishes to correct, because their conduct is open to question, will find ways to use the audit committee in a manner that is perfunctory — or they may even refuse to appoint an audit committee at all. Therefore my hon. Friend the Members for Chichester, for Harrow, East (Mr. Dykes) and for Suffolk, South were right when they suggested that the appointment of an audit committee should be mandatory.

I recognise, however, that it is difficult to legislate when there is such a wide variety of institutions, some of which are outside the scope of British company law. Even if we want changes to the law that will catch companies as a whole on a very wide scale, the House has to recognise that banks are a special case and that it is advisable to let the Bank of England exert the pressure which, in another kind of institution, it would perhaps have been better for shareholders to exert on their own behalf.

I believe that independent directors are very important and necessary in banks and that audit committees are appropriate. We must hope that they will become a regular and established feature of the management of banks. Therefore I accept the compromise amendments that have been worked out and that have been moved by my hon. Friend the Member for Chichester and others. They barely meet the case, but they do meet it for the present, and I am willing to support them. However, I should like to make two comments.

First, the method of conducting the business of an audit committee ought to be spelt out somewhere. There is a wealth of literature on the subject that is based on American and Canadian examples. The way in which audit committees have matured in the last 10 or 15 years in the United States provides us with an example of how audit committees should be operated. If we do not give clear guidance about what the audit committees should be doing, there will be perfunctory or inadequate performance that amounts to nothing and it will waste the time of the people involved. The Bank of England should issue a further code of practice on what constitutes model rules for the functioning of an audit committee.

Secondly, I am concerned that amendment No. 62A as it stands does not place sufficient or, indeed, any emphasis on the appoinment of an audit committee as a desirable practice. We know what the Bank of England has in mind, but if the clause stands as it does at present it will not place emphasis on the appointment of an audit committee— hence my amendment No. 63, which I beg to move. If, therefore, an institution were aggrieved by a bank decision that it did not meet the minimum criteria — in which case it is permitted under clause 25 to appeal to a tribunal —there would be no reason for the tribunal to support the bank's opinion. Surely it would be best to allude to the relationship formally established with the auditors by the independent directors in the relevant schedule to the Bill.

I ask my hon. Friend the Economic Secretary whether he will at least agree to say specifically that the Bank of England will be acting properly if it follows up the consultation paper on the role of the audit committees in banks by insisting, where it sees fit, that the appointment of a properly constituted audit committee should be part of the minimum criteria.

I would be satisfied if the Economic Secretary agreed to that, because I believe that it would give sufficient guidance to people who might be appointed to an appeal tribunal some time in the future, to show that that was what the House intended, even though it did not appear in the actual text. Better still, I should like my hon. Friend to accept my amendment No. 63, which I believe is fully in line with the Government's policy.

Mr. Ian Stewart: I greatly respect the efforts of my hon. Friend the Member for Kensington (Sir. B. Rhys Williams) who, over the years, has advanced the virtues of non-executive directors and audit committees. I believe that he has undoubtedly played a significant part in encouraging the use of audit committees and in drawing attention to the importance of having non-executive directors in companies and, in this context, in banks.

Before I deal with the points of substance, I should like to reply to my hon. Friend the Member for Harrow, East (Mr. Dykes) and other hon. Friends who have suggested that they have not got what they wanted, but that the Bill is not a bad compromise. It is not a compromise as it would not be practicable — repeat what I said in Committee — to introduce the type of measures in the new clauses introduced in Committee, because they have wider implications for company law. In the absence of a clear definition of the responsibilities and functions of non-executive directors and audit committees, there are areas of doubt and dispute that could cause significant problems.

9 pm

I do not wish to labour the point, but if there were definitions of the specific responsibilities attached to non-excecutive directors they would cut across the general legal position of companies and their boards. Therefore, that would have implications for other areas of company law. Directors could evade performance of their duties by claiming to be non-executive directors. A whole range of issues germane to company law make it impossible to introduce workable provisions of the type that my hon. Friend's clauses seek to provide.

There is no resistance on the part of officials or myself to such changes, but Ministers have a responsibility to ensure that legislation that is passed by this House is workable. It was on that basis alone that I differed with my hon. Friends in Committee when I said that rather

[Mr. Ian Stewart]

than introduce my hon. Friend's specific proposals I thought it would be better to introduce provisions on Report that would have the same effect.

I say that by way of explanation because I am glad that my hon. Friend the Member for Chichester (Mr. Nelson) said that he is willing, provided he is given a number of assurances, to withdraw the clauses and substitute the provisions that we have discussed and which I believe meet his needs.

I strongly support the general purpose of the original clauses and the purpose of the amendments now put forward. In Committee there was unanimity in the belief that it was desirable to move in that direction. The only difference between my hon. Friends and myself was a difference of method. In Committee I gave an undertaking to introduce measures, if they could be properly defined, along the lines which are now introduced in the Bill. Therefore, my suggestions in Committee about what should be done have not changed.

I wish to draw particular attention to the significance of the Bank of England paper on audit committees. That paper has been referred to by a number of my hon. Friends. I regard it as a positive statement and that view is shared by the Bank of England. I am aware that it was circulated to members of the Committee and I have placed a copy in the Library so that it is more widely available. I asked the Bank of England to take account of the comments made in Committee when this subject was debated because I thought that it should be aware of the specific points made and I hoped that it would endorse the proposals. I have a response from the Deputy Governor of the Bank of England in which he states:

"The Governor and I have been following with interest the debate in Standing Committee on the role of non-executive directors and audit committees. While welcoming the principles which lie behind the new clauses which the Committee added to the Bill, we entirely share the reservations about their practical effect which you expressed; and I am pleased to learn that it is intended to introduce alternative provisions on Report which will emphasise the importance of non-executive directors, whilst giving the Bank discretion as to the requirement for them in individual cases."

As my hon. Friends will recall, that discretion was on several grounds: the matter of size is relevant, but there is also a question of company structure, such as subsidiaries and parent companies. The Bank of England must take those matters into account.

The Deputy Governor then referred to the consultative paper and continued:

"As you will have noticed, the tone of the paper is direct. The Bank is committed to seeing that all major banking groups establish an audit committee and that in all cases, unless there are sound reasons to the contrary, at least one non-executive director is appointed who can undertake some of the audit committee functions."

The deputy governor asked me to draw that to the attention of the House in this debate and I am glad to do so. It reinforces the provisions now being proposed to be introduced into the Bill. They will be the peg on which the bank can hang its requirements, as part of its prudential supervision, that non-executive directors should be the presumption and that wherever practicable they should be involved in audit committees.

On page 80 the third heading under schedule 3 reads:

"Business to be conducted in prudent manner."

Under that heading the bank has power to apply to individual institutions the requirements which it deems to be necessary for the prudent management of business of a bank or institution of that kind. If we couple that with the clear firm statement of the deputy governor, I can assure my hon. Friends that that means that banks of a certain size will be required, as part of what they need to do to satisfy the supervisor, to have audit committees and non-executive directors.

The importance of that is considerable. It will greatly strengthen the stability of financial institutions. I noted what my hon. Friends said about the implications for going wider into the company sector at large. Obviously, that goes beyond my responsibilities. I can ensure only that the Bill for which I am responsible has the appropriate provisions. Therefore, I hope that the amendments of my hon. Friend the Member for Chichester will be accepted.

My hon. Friend the Member for Kensington said he thought that it would be helpful if model rules were produced by the Bank of England and I shall draw that to the attention of the Bank of England. The consultative paper is designed to answer several specific questions—for example, questions of size. I would not expect such rules to be available now, but after that consultative process is completed the bank in that area, as in all other areas where it requires certain criteria to be met for prudential purposes, will undoubtedly make it clear generally to the institutions what it expects.

My hon. Friend went on to say that, because there was no specific reference to audit committees, the bank could be disregarded in trying to impose non-executive directors and audit committees. Given that it is the intention of the bank to have such provisions, it could not be overruled. It is the Bank of England, as the supervisory authority under this legislation, which will determine, after consultation, the basis of prudent management financial institutions which take deposits. Subject to reservations on the grounds of size or structure, it will require these provisions, and would not regard the requirement that business should be conducted in a prudent manner as being satisfied unless such conditions were met.

My hon. Friend the Member for Kensington asked whether that could be set aside, for example, by the tribunal. The Bank of England certainly would be acting reasonably in insisting on that. It is not the job of the tribunal to second-guess the bank in its judgment on general supervisory requirements. I can give my hon. Friend a full assurance on those points.

I welcome the introduction into statute for the first time of a reference to non-executive directors, as defined in the amendment. This is an important development. It is not necessarily the most important matter that has arisen during consideration of the Bill. Whether or not these provisions were inserted into the Bill, that would have been the requirement in practice as a result of the supervisor's actions. Nevertheless, I welcome the amendment, because it emphasises an important development which is particularly relevant to financial institutions. I shall not try to go wider than that and say what relevance it may have to companies more generally. I note in passing that there are many companies, even quoted companies. The difficulty of recruiting suitable non-executive directors of the right calibre in setting up equivalent provisions for non-deposit-taking companies throughout the economy is a pretty daunting task. Nevertheless, in the case of deposit-taking institutions, this

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development will be important. Therefore, I hope that the amendments of my hon. Friend the Member for Chichester will commend themselves to the House.

Amendment agreed to.

Clause 92

AUDIT COMMITTEES

Amendment made: No. 58, in page 69, line 5, leave out clause 92. *[Mr. Ian Stewart.]*

B

B. BANK OF ENGLAND CONSULTATIVE PAPER ON THE ROLE OF AUDIT COMMITTEES

0773a

BRIAN QUINN

Assistant Director &
Head of Banking Supervision

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

30 January 1987

LETTER TO ALL RECOGNISED BANKS
AND LICENSED DEPOSIT-TAKERS

Dear Sir

I enclose a consultative paper entitled "The Role of Audit Committees in Banks" which encourages the appointment of such committees in the light of the recommendations made in H M Government's White Paper on Banking Supervision issued in December 1985.

The Bank recognises that many institutions may find it difficult to appoint an audit committee with sufficient and suitable non-executive directors. However, the paper does not propose a time scale within which every institution must comply. This will be a matter which the Bank can discuss with individual institutions once the consultative process is over.

Many of the issues discussed in the paper apply to deposit-taking and non-deposit taking companies alike. One exception is the role of the committee in trilateral discussions with the Bank and an institution's auditors or reporting accountants. However, the paper has been prepared with the special position of authorised institutions and the Bank's statutory supervisory responsibilities in mind.

The Bank would welcome written comments from all interested parties by 30 April 1987. While comments from individual institutions are invited, it may be more convenient for members of banking associations and other bodies to pass their comments to their associations so that a submission can be made on behalf of all its members.

Yours faithfully

Brian Quinn

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CONSULTATIVE PAPER BY THE BANK OF ENGLAND

THE ROLE OF AUDIT COMMITTEES IN BANKS

1 INTRODUCTION

2 EXISTING LAW AND AUTHORITATIVE PRONOUNCEMENTS

3 DEFINITION AND DUTIES

4 CHARACTERISTICS AND BENEFITS

5 ORGANISATION AND OPERATION

6 CONCLUSION

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CONSULTATIVE PAPER BY THE BANK OF ENGLAND

THE ROLE OF AUDIT COMMITTEES IN BANKS

1 INTRODUCTION

1.1 The White Paper on Banking Supervision issued by HM Treasury in December 1985 stated that:-.

(a) "Banks should consider the appointment of an audit committee and a finance director where they do not already have them"[1] - the desirability of which is strongly endorsed by the Government.

(b) "It is recognised that this may not be practicable for some smaller institutions and a non-executive director may have a role to play where a fully-fledged audit committee is not feasible".[2]

(c) "While it would not be appropriate for there to be legislation in the area, the Bank of England will be discussing with individual institutions the application of these concepts".[2]

1.2 The purpose of this consultative paper is to encourage , where appropriate, the appointment of audit committees. It seeks to define the basic functions of an audit committee in a banking environment and to suggest how they should be established and how they can operate effectively. There is also a description of the role of non-executive directors who have an important contribution to make to the work of audit committees.

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(1) Chapter 8, paragraph 8.1 (vii)

(2) Chapter 8, paragraph 8.10

2 EXISTING LAW AND AUTHORITATIVE PRONOUNCEMENTS

Audit Committees

2.1 UK company law does not require the appointment of an audit committee and there has been no great pressure for it to do so. In 1977 the Consultative Committee of Accountancy Bodies (CCAB) suggested to HM Government that, while experimentation with audit committees by companies should be encouraged legislation requiring their appointment would be premature. In 1979 the Auditing Practices Committee (APC) of the CCAB published an explanatory booklet on the role of audit committees in UK companies but stressed the need for further experience in their operation.

2.2 HM Government's White Paper "The Conduct of Company Directors" published in November 1977 recognised that audit committees could strengthen the influence of non-executive directors and the position of auditors. On the subject of legislation it was stated that "the time may come when it will be appropriate to legislate in this field, but the Government believes initially at least it will be better for companies, investors and their representative bodies to work out schemes which can benefit from a degree of flexibility which the law could not provide".

2.3 A Private Member's Bill placed before Parliament in 1983 proposed that every public listed company with assets of more than £5 million and more than 1,500 employees should have at least three non-executive directors. It also proposed that all companies with assets more than £100 million or employing more than 10,000 people should have an audit committee. The Bill failed mainly because of concern that there were insufficient persons qualified to act as non-executive directors. Progress is being made to remove that concern. A study of quoted companies published by the Bank of England in its Quarterly Bulletin, June 1985, shows that on average one in three directors of companies of the size referred to in the Bill is non-executive and in 60% of the companies examined, the board included three or more non-executive directors.

2.4 There are no proposals relating to audit committees in current or proposed EC directives for company law harmonisation. The supervisory board within the two tier board system envisaged by the European Commission has some objectives similar to those of an audit committee in that it reviews the progress of a company's affairs, its draft annual accounts, and its strategic planning and operating policies.

2.5 The Stock Exchange has not made any recommendations about audit committees but has let it be known that it welcomes their introduction on an experimental basis.

2.6 Promotion of Non-executive Directors (PRO NED), a body set up and sponsored by the Bank and, in the main, a group of City institutions representative of industry and finance, has helped to promote the wider appointment of non-executive directors and to encourage the use of audit committees.

2.7 In the United States the appointment of audit committees has been encouraged by the American Institute of Certified Public Accountants (AICPA) and the Securities and Exchange Commission and it is a condition of listing on the New York Stock Exchange (NYSE). A statement issued in 1967 by the AICPA said that the purpose of an audit committee was "to nominate the independent auditors of the corporation's financial statements and to discuss the auditors' work with them". The NYSE stipulates that an audit committee should be made up solely of "directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgement as a committee member". In a recent legal case it was ruled that the audit committee had not only to review the results of the independent audit but also to review the company's code of conduct and any case of non-adherence to it, all published financial statements, and activities of officers and directors in dealing with the company.

Non-Executive Directors

2.8 The Bank of England Bulletin article referred to in paragraph 2.3 refers to the need for non-executive directors to be capable of taking an objective view of the policies and views advanced by the management and PRO NED refers to the major contribution they can make to the quality of board discussion and decision-taking - they can "provide the board with knowledge, expertise, judgement and balance which may not be available if the board consists only of full-time executives".

2.9 A booklet, the "Role of the non-executive director", issued by PRO NED in 1982 states that non-executive directors have a particular role on audit committees where they should be in a majority to ensure independence from management. This, the booklet says, makes the appointment of non-executive directors, ideally with financial experience and expertise, highly relevant, especially where a company decides to create an audit committee.

2.10 The analysis and conclusions of these various bodies is confirmed in the Report of the Committee set up to consider the System of Banking Supervision published by HM Government in June 1985. This states that "audit committees, which are normally composed largely of non-executive directors, can play a particularly useful role in monitoring the operations of a bank. Non-executive directors should ensure that they are given sufficient information to be able to satisfy themselves that the policy guidelines and systems approved by the board are being followed"(3).

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(3) Chapter IV, paragraphs 4.2 and 4.3.

3 DEFINITION AND DUTIES

3.1 An audit committee is a sub-committee of the board of directors on whose behalf, under whose authority and within whose terms of reference it acts and to whom it reports. While it does not have executive responsibilities it can assist the board by watching over certain aspects of an institution's operations and certain external relationships. Audit committees should not oversee the day-to-day work of executive directors, this being the collective responsibility of the whole board.

3.2 The terms of reference of an audit committee will have regard to the circumstances of the business, and should take account of the time which its members can be reasonably expected to devote to its affairs. Thus while it should probably meet at least two or three times in a year it would be unreasonable to expect more than, say, five or six meetings each year. The terms of reference for the audit committee of a bank typically include a request:

(a) to examine the manner in which management ensures and monitors the adequacy of the nature, extent and effectiveness of accounting and internal control systems;

(b) generally, to review the bank's statutory accounts and its other published financial statements and information;

(c) to monitor the bank's relationship with its external auditors, to ensure that there are no restrictions on the scope of the statutory audit; to make recommendations on the auditors' appointment, remuneration and dismissal; and to review the activities, findings, conclusions and recommendations of the external auditors;

(d) to review arrangements established by management for compliance, though not compliance itself, with regulatory and financial reporting requirements contained in statute with the requirements of supervisors; and

(e) to consider whether an internal audit department is required, to review the scope and nature of its work, to recommend to whom it should report and to receive and review its reports, findings and recommendations. Where an internal audit department is not considered necessary the audit committee should be satisfied that adequate alternative controls are established.

3.3 The audit committee should report to the board of directors, in accordance with its terms of reference. Any matter which, exceptionally, it believed it was essential to bring to the attention of shareholders should be handled through existing channels of communication. Since it is not appropriate for the audit committee to have executive powers the board resolution which establishes the committee should make this clear. This resolution can also affirm that the committee is not responsible for supervising the performance of executives and is not required to become involved in day-to-day operations, management functions or decision-making.

4 CHARACTERISTICS AND BENEFITS

Review and Monitoring of Control Environment and Exercise of Statutory, Fiduciary and Common Law Duties of Directors

4.1 Perhaps the most significant benefit from the introduction of an audit committee with terms of reference of the kind described in the previous section is the contribution that it can make to establishing and maintaining an effective control environment. This in turn helps the board fulfil its statutory and common law responsibilities to shareholders and its duties to employees, customers and depositors. Directors have a fiduciary duty to act in the interests of the company, and duties to exercise care and skill, to observe the utmost good faith towards the company, and to act honestly in the exercise of their powers. While these duties are part of common law and are not defined in statute, case law has shown that they must be exercised with reasonable care and with those skills which can be reasonably expected from a person of his knowledge and experience.

The creation of an effective audit committee is confirmation that the board is seeking to carry out its responsibilities with reasonable care, diligence and skill and helps to protect it from the uncertainties which arise from the absence in company law of a clear statement of duties and responsibilities of a board of directors.

Defined Role for Non-Executive Directors

4.2 The appointment of an audit committee can reinforce the role of non-executive directors. The absence of a generally accepted role can make it difficult for non-executive directors to make an effective contribution to the conduct of a company's affairs. Service on an audit committee would help them become better equipped as members of the board.

Strengthening of Objectivity and Credibility of, and Public Confidence in, External Financial Statements

4.3 A further benefit is the strengthening of the objectivity and credibility of the bank's external financial reporting. The nature of a bank's business and the need to preserve public confidence arguably sets a high premium on directors' judgment in the preparation and presentation of external financial statements. By reviewing the exercise of this judgment the audit committee can contribute to confidence in the quality of reporting.

Effective Forum for Communication between Non-Executive Directors and External Auditors

4.4 An audit committee can be a useful vehicle for contact between non-executive directors and the external auditors. While auditors normally attend board meetings at which the statutory financial statements are approved, or significant matters of concern to them are discussed, such meetings are not normally an appropriate occasion for the discussion of detailed matters of accounting and internal controls, for example. An audit committee can be used as a forum in which such matters can be discussed and most audit problems resolved on a timely basis and in more depth than would be practicable at a full board meeting.

Contribution to Quality of Accounting Function

4.5 An audit committee could contribute to the quality of the accounting function within a company by being the focus for the discussion of proposals and recommendations relating to financial management and reporting and the work of the internal auditors.

5 ORGANISATION AND OPERATION

Terms of Reference Set by Board

5.1 Audit committees should be appointed by a formal board resolution. This resolution should include a statement of its terms of reference. These terms will vary with the board's perception of the audit committee's role, with the size of the institution, and the nature of the different types of business conducted. While it need not contain a detailed description of the committee's functions it is important for it to include a description of the framework within which it will operate.

Detailed Record of Duties and Functions

5.2 Once established the audit committee should prepare, and from time to time review, a detailed description of its duties and functions.

Reporting to Board

5.3 Since the audit committee acts on behalf of the main board and reports to it the agenda for board meetings should provide for a verbal or written report from the chairman of the audit committee on its findings, conclusions and recommendations. It may also be appropriate for the minutes of audit committee meetings to be circulated to all board members.

Chairman of Audit Committee

5.4 The chairman of the audit committee should be appointed by the main board at the same time as it appoints the committee itself. Ideally, the chairman should be a non-executive director, have business experience in an executive capacity, have some knowledge of accounting and auditing matters and be up to date with pronouncements from the supervisory authorities.

Committee Members

5.5 The directors appointed to the audit committee should be able and willing to accept the related responsibilities and should have relevant experience and skills. All members of the committee, including its chairman, should be independent of financial management and of any responsibility for the accounting, internal control and auditing functions in the bank and be free from any relationship that could interfere, or be seen to interfere, with their objectivity and the exercise of their individual independent judgment.

5.6 An audit committee should have sufficient members to fulfil the duties set by its terms of reference. Ideally, they should have a range of experience which is derived from both business and professional appointments. It is unlikely that an audit committee can function effectively unless, in addition to the chairman, at least one member (preferably two or more) is a non-executive director.

5.7 Not all banks will have sufficient non-executive directors to form an effective audit committee alone. In such circumstances and where the bank is a subsidiary company, consideration should be given to appointing to the board and audit committee of the bank, a non-executive director of its holding company. Where executive directors are appointed the principle of independence might be preserved by appointing directors whose executive duties exclude them from direct participation in, or functional responsibility for, day-to-day financial decisions, for accounting and internal control systems and for statutory accounts preparation.

Frequency of Meetings

5.8 The number of meetings held by an audit committee during the year will largely depend on the extent of its duties but as mentioned in paragraph 3.2 it would not be realistic to expect it to meet more than at most five or six times each year.

Relationship with External Auditors and Supervisors

5.9 It is not appropriate, at this stage in a new and evolving environment, to give the audit committee a role in the relationship between a bank's auditors and the Bank and other supervisory authorities. However, the audit committee should receive copies of correspondence and minutes, where taken, of meetings between supervisors, management and auditors and in certain circumstances it might be considered appropriate for a member to attend a trilateral meeting with auditors and supervisors.

6 CONCLUSION

While it is unlikely that circumstances will enable all banks to appoint an audit committee, the duties and functions of the audit committee described in this paper, where these are appropriate to the size and nature of a particular bank's business, should be undertaken by the board or by a sub-committee of the board. This committee thus becomes a means by which a board can conduct and be seen to conduct its affairs, and discharge and be seen to discharge, its duties in a responsible and effective manner. Nevertheless, the Bank considers it appropriate that the boards of authorised institutions above a certain size should appoint an audit committee. (The Bank would, in particular, welcome suggestions for the criteria for deciding what this size should be). Where the institution is not large enough to justify the appointment of a committee it should appoint at least one non-executive director, who, while not expected to fulfil the role and function of an audit committee, would, in particular, be available to discuss any matters of especial concern to the auditors if this became necessary.

Banking Supervision Division
Bank of England
January 1987

From: Sir Brandon Rhys Williams, M.P.

DEG PS/MH

HOUSE OF COMMONS
LONDON SW1A 0AA

16th February 1987

Rt Hon Paul Channon, MP
The Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H OET

Mr Steel C
ASAP.
COPIES TO:
PS/Mtt.
PS/Sir B.H.
Mr Caine
Ms Brown

Dear Paul,

Audit Committees

I was glad to see you last week, because I feel that the Government should be taking practical steps to assist self-regulation, both in banking and in the wider field of public companies as a whole.

The object of all my Companies Bills since 1969 has been to increase the authority and status of the elements within public companies which could be exercising a more effective supervisory role. The privilege of limited liability places the shareholders under an obligation to ensure that their enterprises are competently and honestly managed. In public companies they cannot directly supervise what is being done by the senior executives. They accordingly must rely on the chairman, where this office has not been taken over by the managing director; or the non-executive directors, where they exist and where they are genuinely independent; and on the auditors.

I am in the middle re-drafting the bill which I introduced in the 1985/6 session and previous years and - as you will have noticed - I have revised the long title and postponed the date of the Second Reading until 1st May. I would like to bring out the printed text by the end of this month in order to give ample time for all concerned to study the implications. If I could have the benefit of the co-operation of your department in settling the details and the precise form of words, it would be most helpful.

On previous occasions, I have hoped that the Bill could reach the end of the Commons Committee Stage in order to attract attention to my particular proposals and to have the chance to refute the objections which are regularly raised by people who are content for the present state of affairs to continue, or who prefer that free enterprise should increasingly be subjected to regulation by public officials. This year I feel

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that the need to improve the supervision of executives of public companies has become so obvious that Parliament would be right to carry a limited measure right through into law without any more procrastination.

My main concern is not the recent rash of frauds and city scandals so much as the general loss of moral tone and the sluggishness of management in scores of companies where the senior executives are not being subjected to healthy curative pressures from within their own organisations. In all too many cases they are content to put up a mediocre performance or to rely on obsolete methods. These are the conditions where dishonesty and malpractice can too easily gain a hold; but the most serious damage to the economy is done by the inefficient use of human and material resources.

My aim, therefore, is to produce a Bill which, building on existing company practice, will make the minor changes in formal procedures and the rights of the shareholders that are needed to set the balance right within the ranks of the senior executives, the board of directors and the auditors. I do not recommend my Bill as a panacea, but as a small step which is long overdue.

In German companies over the past hundred years, as businesses have grown too complicated to be supervised directly by the shareholders, the practice has become established of appointing a supervisory board to conduct a permanent "management audit" on behalf of the owners. In North America, the normal practice is still to elect a unitary board, but to maintain a majority of outside directors who then appoint a committee from among themselves (the "Audit Committee"), to carry out a regular supervisory function in conjunction with the auditors. In Britain, we have done neither. The results are painfully obvious.

I attach a note about the present state of my draft Bill. May I look to you for help?

Yours ever
Brandon

Brandon Rhys Williams

NOTES FOR DRAFT OF COMPANIES (AUDIT COMMITTEES) BILL, 16 FEBRUARY 1987. BRANDON RHYS WILLIAMS

LONG TITLE

BILL TO AMEND THE LAW RELATING TO THE ELECTION AND RESPONSIBILITIES OF DIRECTORS OF COMPANIES AND TO THE COMPOSITION OF BOARDS OF DIRECTORS; TO MAKE PROVISION CONCERNING THE APPOINTMENT OF INDEPENDENT NON-EXECUTIVE DIRECTORS; TO REQUIRE PROCEDURES TO BE FOLLOWED IN CERTAIN PUBLIC COMPANIES IN REGARD TO THE APPOINTMENT AND FUNCTIONING OF AN AUDIT COMMITTEE OF THE BOARD; TO MAKE FURTHER PROVISION IN REGARD TO THE RESPONSIBILITIES OF AUDITORS; AND TO MAKE OTHER CHANGES IN THE LAW RELATING TO COMPANIES.

PARTICULAR AIMS OF THE BILL

1. To convey more information to the shareholders about the composition of the board and the candidates seeking election as directors; to make it easier for candidates other than those proposed by the existing board to make known their candidature and personal particulars to the shareholders in advance of the meeting at which the election takes place.

NOTE Appropriate procedures in regard to elections of directors have now been incorporated in "Table A", Regulations 76 to 80, but these, of course, apply only in companies formed since 1985. They can only be made standard practice in all public companies if they are now made statutory.

It would be appropriate to add to the Companies Act

Section 289 at the end of 1 (a) (v):-

"his previous business or professional experience and qualifications."

The Directors Report should carry the particulars which are required to be kept in the company's register under Section 235, i.e. in

Schedule 7 Part 1 there should be added:-

"2 (4). The report shall include the particulars contained in the register under Section 289."

2. To make more specific the requirements implied by Schedule 7 Part 1, 6 (b) of the 1985 Act which reads;

[The directors report shall contain -].....
(b) an indication of likely future developments in the business of the company and of its subsidiaries."

A new clause is needed on the following lines:-

(1) The directors of every public company shall secure and collate not less than once in each accounting reference period such data about the company's affairs and transactions and those of its subsidiaries and prepare such estimates of the future course of the business as are necessary to enable a reasonable assessment to be made of the future ability of the

company to carry on business as a going concern and to pay its debts as they fall due.

(2) The data and estimates prepared in pursuance of sub-section (1) above shall be provided as soon as reasonably practicable to all the directors of the company, to the company secretary and to the auditors.

To make it a responsibility of the auditors to inform the shareholders if they consider the directors are not complying properly with the requirements of schedule 7, Part 1, 6 (&), the requirements relating to the Auditors' Report should be amended to include a statement as to whether the Directors' Report has been properly prepared insofar as it is required to comply with the provisions of Schedule 7 Part 1.

It would also be appropriate to add at the end of Schedule 7 (3) (1), after 'purposes or both' the words "or for any other purpose", in order to bring within the scope of the Schedule irregular payments such as subsidies for purchasers of the company's shares.

3. To give strong encouragement to public companies (except small and medium-sized companies, by the recognised definition) to appoint an audit committee

of the Board consisting wholly of genuinely independent non-executive directors.

The method proposed is to make it possible even for relatively small shareholders, or a small group of shareholders, to place a resolution on the agenda of their company's A.G.M. requiring the board to set up an audit committee in accordance with the Model Rules attached as a Schedule to the Bill. As with other changes in the articles, it is accepted that the resolution has to win 75% of the votes of the meeting in order to be passed (i.e. it must be an "extraordinary resolution"), and that the company will be free to adopt its own rules for the conduct of the audit committee, (deviation from the Model Rules, however, also requiring an extraordinary resolution).

It is suggested that the process of appointing audit committees in substantial public companies should be accelerated by the Stock Exchange, which should make it a condition of listing that all companies in the 'alpha' list should have appointed an audit committee by a certain date, established, except by permission of the Exchange, in accordance with the Model Rules, followed as soon afterwards as practicable by the companies in the 'beta' list. That would take in some 600 public quoted companies and would follow the initiative of the New York Stock Exchange, which instituted this requirement some ten years ago for all listed companies. The Stock Exchange should insist that all members of the

Audit Committee should be independent directors.

The Bank of England should also make the appointment of an audit committee an obligation of the majority of the larger banking institutions at its own discretion.

4. To include in statute a definition of an "independent" non-executive director.

To rebut any suggestion that this proposal would introduce a new element into the statutes relating to the board of directors - the precise opposite is of course the truth - the definition might best be framed so as to exclude directors who have accepted executive responsibilities, such as the managing director and the other directors who have taken on commitments additional to those normal for a director under provisions such as those outlined in Table A, Regulations 84 and 85. In previous Bills I have been recommended to rely on the following definition....."
a director who is not an employee of and does not hold any office or place of profit under the company or any subsidiary or associated company of the company in conjunction with his office of director of the company; "

It would be necessary to establish that service as a member of an audit committee, even if rewarded by special remuneration, would not disqualify a director from eligibility to be counted as an "independent" director.

From: Sir Brandon Rhys Williams, M.P.

cc DTI
EST
cc G. Guise

R25/2

HOUSE OF COMMONS
LONDON SW1A 0AA

24th February 1987

The Rt Hon Margaret Thatcher, MP

Dear Margaret,

Self Regulation - The Appointment of Audit Committees.

I am concerned that the government is not doing more to make self-regulation more effective in the private sector. We have had too many highly publicised instances of companies where inadequate internal guidance has permitted executives to lapse into malpractice and fraud; but I believe that the much more serious aspect of the weakness of the supervisory elements in the normal structure of British public companies is the general decline in the quality of management. Too many companies are failing to make the most of their opportunities and are not putting their human and material assets to the most effective use.

Although as a party we have faith in free enterprise and are committed to self-regulation as the right means to promote good business practice and efficiency, we are not yet doing what is needed to enable companies to solve their own problems. We have been successful in promoting wider share ownership in some large and conspicuous concerns, but the purchase of shares in medium-sized, and even quite large public companies, is still a hazardous way of investing small savings.

Because Parliament has given shareholders the privilege of limited liability, it is not simply a matter of common prudence but a duty to the public in general for them to seek to ensure that their enterprises are properly managed. Unfortunately, in the past hundred years or more, the size and complexity of business activities have grown so much that it is impossible for shareholders to exercise direct supervision. They are obliged to rely on agents appointed to act on their behalf with access to inside information - in particular the auditors and the non-executive directors. This is a method of control which in Britain is not working well enough.

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Parliament should be putting this right.

In North America, as in Britain, the great majority of companies have a single board of directors consisting of full-time senior executives and a number of outsiders. It is normal, however, for the 'independent' directors to be in the majority. This is a feature which has now become a rarity in British companies except in banking and insurance.

Moreover in Canada and the United States it has become established practice to appoint committees of directors with responsibility for carrying out particular supervisory functions on behalf of the board as a whole. Of these committees the audit committee is possibly the most important because it confers a degree of authority on its members and provides them with independent professional support. It broadens their insight into the whole range of the company's activities, not just the financial and accounting functions. Very few British companies have yet followed this example.

In Britain, in the 19th century, it was expected that the directors would all be non-executive. One might say that at that time the boards of directors of British public companies were close to the German model of the "aufsichtsrat"; but whereas in Germany the supervisory board has developed as a separate organ of the enterprise, in Britain what might be called a managerial revolution has changed the whole character of public company boards and enabled the senior executives to take over the majority of the places. Directors who are genuinely independent of the full-time management are now something of a rarity and are almost always in a minority. Many so-called "non-executive" directors are in fact former employees or advisers of the company, or are still providing a part-time service in one capacity or another. Their judgement is not entirely free and they depend on the executive directors for their re-election.

Because in Brtain we have followed neither the German nor the North American practice, the control of many British public companies is suffering from a serious organisational weakness. I am convinced that quite small changes in the statutory procedures would put shareholders in a position to set matters right. I have accordingly come forward in every session of Parliament since 1969 with proposals to make self-regulation in public companies more effective. In

cont'd....

The Rt Hon Margaret Thatcher 24th February 1987

particular I have suggested ways of giving the auditors and the independent directors a greater degree of authority within the existing framework of the company.

The Department of Trade, unfortunately, is hostile to this approach and has used Parliamentary time year after year for a series of measures designed to govern the conduct of private-sector businesses from the outside. They have instituted much more complicated regulations, more detailed reporting procedures, harsher penalties for failure, increased powers for inspectors and greater interference by a range of new official bodies. Each of my Bills since 1972 has been blocked on the instructions of the Department, and on the occasions when I have secured a debate the official response has been disappointingly superficial.

My campaign has not been entirely fruitless. Two minor reforms which I have regularly recommended to give more information to the shareholders were introduced in 1985; and last week the Banking Bill was amended to give powers to the Bank of England to insist on the appointment of independent directors in deposit-taking institutions with a view to the establishment of formal internal audit committees wherever the Bank considers it to be appropriate.

We should now take steps to make it easier for share-holders in large and medium-sized companies to assess the composition and quality of their boards and - wherever they see the need- to propose the setting-up of audit committees made up of genuinely independent, properly informed and professionally supported non-executive directors. It would not take very long to find suitable men and women to serve on audit committees in the alpha and beta lists of companies quoted on the Stock Exchange, which would catch about five hundred of the largest undertakings.

I have asked Paul Channon to let me have the co-operation of his Department in revising the Bill which I have set down for 1st May; I am sure that if I could produce a well-drafted text which could be seen to put self-regulation in public companies on a more practical footing, it would evoke a very favourable public response. He has not yet replied, however, and I am grateful to you for agreeing to see me on Thursday.

Yours ever

Brandon

BRANDON RHYS WILLIAMS

MR 1/87

cc BS
Chap

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 November 1986

David Norgrove Esq
10 Downing Street

BIF 26/11 please

Dear David,

SIR BRANDON RHYS WILLIAMS

I attach a brief for the Prime Minister's meeting on Thursday, covering the points in Sir Brandon's paper.

Yours
Alex

A C S ALLAN

MR 1/87

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 November 1986

David Norgrove Esq
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SIR BRANDON RHYS WILLIAMS

I attach a brief for the Prime Minister's meeting on Thursday, covering the points in Sir Brandon's paper.

Yours
Alex

A C S ALLAN

SIR BRANDON RHYS WILLIAMS: STERLING AND THE EUROPEAN MONETARY SYSTEM

Sir Brandon Rhys Williams' paper is one he gave recently to the European League for Economic Cooperation.

2. It starts by making some familiar points about the difficulties of sterling joining the exchange rate mechanism of the EMS, but draws a rather different conclusion from usual: that we should put all our efforts behind moving as rapidly as possible towards full monetary union. This would include the end of national currencies and a supra-national bank with 'regulatory powers outside the range of national political influences'.

3. This is a familiar vision, but it is not one Europe could achieve at one bound, even if the combined political will was there. Monetary union is a long-term objective of the Community's, but we need to advance towards it by practical steps.

4. The most important is to work towards convergence of economic policies aimed at stable, non-inflationary growth. This is an objective the UK Government has pursued consistently.

5. We fully support a number of the other steps Sir Brandon Rhys Williams mentions:

(i) Liberalisation of capital controls. We have already abolished our restrictions on capital movements, and fully support Delors' objective of liberalising all capital movements within the EEC by 1992. At ECOFIN on Monday, under the Chancellor's chairmanship, the first directive on capital market liberalisation was agreed. This will increase the range of financial transactions which have to be covered by a specific derogation from the treaty if controls on them are to be maintained. Work on a second, more ambitions, directive will now start.

(ii) Removal of other barriers. We fully support the objective of ending taxation anomalies, protective local regulations, and restrictive practices.

6. Sir Brandon Rhys Williams may raise the slow progress on monetary co-operation since the EMS was set up in 1978. The European Council in July 1978 said that "not later than two years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund". The Council in December 1978 reaffirmed the two-year timetable and added that the package would also include "full utilisation of the ecu as a reserve asset and a means of settlement". In practice, enthusiasm for large-scale reforms soon waned, though some progress continues to be made: last year, the Bank of England and other EC central banks agreed on a package of measures to improve the usability of the 'offical ecu' while allowing further development of the 'private ecu' free of controls. The UK already permits the free use of the 'private ecu' - indeed, London is the centre of the ecu market - and we fully support relaxations of restrictions in other member states, so that a private ecu market can develop its full potential. The Single European Act in 1986 simply noted that Member States had "taken a number of measures intended to implement monetary co-operation", and agreed to carry the work forward.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

11 November 1986

Sir Brandon Rhys Williams has asked to see the Prime Minister to discuss the note enclosed, and an appointment has been made for 20 November. I should be grateful for a brief by close on Tuesday 18 November.

(David Norgrove)

Mrs. Cathy Ryding,
HM Treasury.

European League for Economic Cooperation (ELEC) B/UP

Monetary Panel Meeting - London 10.30 am 28 October 1986

C/o Britannia Arrow Holdings 80 Coleman Street, EC2

Notes contributed by Sir Brandon Rhys Williams MP

(Vice-President British Section)

****

Sterling and the European Monetary System

The Big Bang which is taking place in London this week is not an isolated event. It is merely the end of the beginning of a process by which London is becoming a fully open market for capital, without the restrictions imposed either by official regulations, or by informal and traditional restrictive practices. But the process of liberalisation has still a long way to go. To judge the significance of the Big Bang we have to see clearly what will come next.

What has to come next is not a matter for London alone. It is the consolidation of European monetary institutions, conditions and facilities to create a genuine, perfectly integrated internal European market for capital. We must organise our time-zone, working together in a joint act of will to make the most of the opportunities lying open to us between Tokyo and New York.

Many people have sought to insist that sterling should now be integrated into the EMS; but we have to be more ambitious and at the same time more realistic than that. This would not be the right moment for Britain to make commitments to hold sterling to a fixed rate of exchange in relation to the

other currencies of the EEC, while it remained free to float against the dollar and the yen. The idea that Europe can proceed into the forseeable future as a multicurrency area, run on civilised lines with all the currencies of the nation states following orderly courses has obvious theoretical attractions; but that is not the result that would be achieved if sterling were simply to join the EMS at this juncture. Such a move would turn the EMS into a solar system with two suns moving eccentrically, the pound and the D-mark having developed - as yet - no binding commitments towards each other or to the other currencies in the system.

In the circumstances of today we have not yet achieved the necessary degree of integration of the European capital markets for near-perfect arbitrage of the kind that can be seen to exist between Chicago and New York, for example, or Paris and Lyon, or Frankfurt and Hamburg. As a member of the EMS the pound would be likely to become a focus of instability and speculation. Such an outcome would benefit no-one. Adopting a convention of specially wide bands would only be a partial solution; and it would diminish the advantages of sterling membership for all concerned. If the depreciation of sterling continued even marginally faster than that of other currencies in the system, either the pound would again become increasingly overvalued, which would do further damage to our industries; or there would have to be adjustments which would tend to shake the whole system.

More serious, until such a time as we have brought the operation of the European financial centres so close to each other that any divergences of conditions become self-correcting by instantaneous arbitrage, there will continue to be a risk that capital movements will affect conditions more in one centre than in the others; and London, being the place where facilities for speculation are conspicuously present, is the financial capital most likely to be driven off course. Ironically enough, as London becomes more and more free, it becomes more difficult, not less, to attach the pound to a fixed exchange rate system.

If a change of market sentiment were to affect sterling more seriously than another major member currency of the EMS, an adjustment of interest rates might be sufficient to restore an adequate, though probably temporary equilibrium within the system. But when differentials between interest rates have been pushed to their limits, speculation against the most detachable currency can only be carried on the rate of exchange.

No single national central bank within the EEC has reserves so large that it could confidently now defy a panic movement of capital from inside and outside the system. Even if monetary authorities in one particular place could rely on the co-operation of all the monetary authorities in all the other centres, there is still no certainty that a sudden surge of speculative capital could be neutralised by official intervention alone.

This analysis should not lead us to despair, but rather to a redefinition of our aims. The idea that Japan can enjoy the benefit of the Tokyo capital market, with all the advantages of a single domestic currency,and the United States can rely on a single domestic currency in support of New York, while Europe contrives - somehow - to compete into the distant future with a capital market resting shakily on a multicurrency system is quite unconvincing. The relative failure of our economic achievement in recent years proves the fallacy of this notion. While the rest of the industrial world makes giant strides forward, Europe continues to repeat the mistakes of the 1930's.

The European Economic Community therefore must hasten to complete its agenda. It is not enough to perfect the internal market for transactions on current account: we must move rapidly forward on capital account as well.

What does the creation of an integrated European market for capital really entail? It means that we must prepare to relinquish the independent decision-making power of the national central banks. An integrated capital market requires a single monetary authority with regulatory powers outside the range of national

political influences. It means the final end of taxation anomalies, protective local regulations and restrictive practices. It calls for the amalgamation of national monetary reserves. It will involve - this has to be faced - the end of national paper currencies. Europe must prepare to adopt a single monetary unit, to serve as a measure of value and store of value for the whole of our continent and the rest of the world besides. For Britain the choice is not whether to join or not to join the EMS while we continue to run our affairs more or less as before. If we do not quickly make a success of our membership of the European Economic Community we shall be unlikely to make a success of anything else. We have allowed the sterling area to disintegrate; now the pound is neither a large enough currency to compete with the dollar and the yen on level terms, or small enough to hang on to some other national currency in a subordinate role. In London, however, we can be confident of a great future if we can rely on the development of an increasingly intimate relationship with the financial centres of the continent. I believe that we can, and must. There is no time to waste. In economic affairs, nationalism is not enough.


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